

STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 94-254

May 15, 1995

FREDERIC A. PEASE ET AL. V.
NEW ENGLAND TELEPHONE AND TELEGRAPH
COMPANY D/B/A NYNEX
Re: Complaint Requesting Commission
Investigation of the Level of Revenues Being
Earned by NYNEX and Determination of Whether
Toll and Local Rates Should be Reduced

ORDER

WELCH, Chairman; NUGENT, Commissioner

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I. INTRODUCTION AND SUMMARY OF DECISION

The purpose of this investigation is to determine the proper level of revenues and earnings for New England Telephone and Telegraph Company d/b/a NYNEX (hereinafter referred to as NYNEX). Because we adopt an Alternative Form of Regulation (AFOR) in the companion case, Docket No. 94-123, Public Utilities Commission, Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company d/b/a NYNEX, our revenue requirement findings set forth in this Order will also be the starting point for rates under the AFOR. We find, after examining the evidence before us, that NYNEX shall file rates to decrease its Maine intrastate revenues by \$10.446 million. This decrease shall be accomplished by eliminating charges for Touch Tone service, and by reducing rates for toll services. NYNEX shall also provide up to \$4 million per year in rate reductions and/or other benefits for libraries and schools. We further find that NYNEX shall issue a one-time credit to all customers of \$2.8 million.

The Commission appreciates the efforts of all the litigants, and especially the Commission's Advocacy Staff, in meeting the very aggressive schedule for the completion of this case. The evidence and argument presented to us was thoughtful, thorough and greatly assisted the Commissioners in their task of understanding, and balancing, the interests involved.¹

II. COST OF CAPITAL

Based on the evidence in this record, we find that the Company's² overall cost of capital is equal to 10.44%. We further find that our best estimate of the Company's cost of common equity, including flotation costs, is 12.50%. Our findings on the overall cost of capital are shown in the following table:

¹The procedural history of this case and the companion case, Public Utilities Commission, Investigation Into Regulatory Alternatives for New England Telephone and Telegraph Co. d/b/a NYNEX, Docket No. 94-123, hereinafter referred to as AFOR Order, is appended to this Order as Appendix A and is incorporated by reference into this Order.

²As used in Part II (Cost of Capital) of this Order, the term "the Company" refers to the Maine jurisdictional operations of NYNEX, which, in turn, is a subsidiary of NYNEX Corporation. The term "NYNEX Corp." refers to the market-traded parent company of the Company.

| Component | % of Capital | Cost Rates | Weighted Cost Rates |
|-----------------|--------------|------------|---------------------|
| Long-Term Debt | 39.36% | 7.48% | 2.94% |
| Short-Term Debt | 1.28% | 6.00% | 0.08% |
| Common Stock | 59.37% | 12.50% | 7.42% |
| TOTAL | 100.0% | | 10.44% |

A. Guiding Principles

A utility is entitled to an opportunity to earn a fair rate of return on its invested capital. The overall rate of return must be high enough to allow the utility the opportunity to secure the funds needed to invest in its business, but it cannot be so high that it becomes an unreasonable burden on ratepayers.

The general principles under which a utility's cost of capital are determined are set forth in several often-cited U.S. Supreme Court cases. Those cases are *Bluefield Water Works v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944); and *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). The Hope and Bluefield cases establish that regulated utilities must be given the opportunity to earn returns that are sufficient to attract capital and allow the utility to maintain its financial integrity, and are comparable to returns that investors would expect to earn by investing in companies with a similar degree of risk. The returns are not guaranteed, and as the Permian case makes clear, the concerns of investors are to be weighed against the interests of ratepayers.

The Maine Law Court has also required the Commission to consider the interests of ratepayers when setting the fair rate of return. Ratepayers' interests must be given substantial weight in the final determination of a utility's allowed overall rate of return. *New England Telephone and Telegraph Company v. Public Utilities Commission*, 390 A.2d 8, 30-31 (Me. 1978). Thus, we must look both at the costs that the utility incurs to attract capital, and at other factors affecting the broad public interest, before arriving at a fair return for the utility.

We will initially consider the cost portion of our analysis. This is the price that the market requires the utility to pay to obtain capital. Like any other publicly-traded company, a utility must seek funds from investors to conduct its business. The utility competes with all other firms in attempting to attract debt and equity investors. Thus, the marketplace sets the prices that the utility must pay. Of course, the utility must take all reasonable and prudent steps to minimize that cost.

First, an appropriate capital structure must be determined. Because rates are set prospectively, that structure should represent the relative proportions of debt and equity that will be (or should be) in place during the rate-effective period. Second, the cost of debt and preferred stock (if any) is generally determined straightforwardly because the cost rate is determinable from the instrument itself. Sometimes, however, controversy arises as to the exact calculation.

Third, the cost of common equity must be determined. There is often substantial disagreement among the parties in any rate case regarding the appropriate cost of equity, because the cost that the utility must pay for equity capital cannot be measured with certainty or precision. The market from which the utility obtains capital is a vast and diverse mixture of participants, whose many required returns are embodied in a single market price. In addition, our allowed overall rate of return must be set prospectively, using an estimate of future "prices" to attract equity capital.

Finally, the overall cost of capital is established by using the appropriate proportion of each component of capital structure and the appropriate cost rate for each of the component parts. The weighted average sum of the components equals the overall cost of capital.

In addition to the cost portion of our analysis, we must consider other factors affecting the broad public interest before arriving at the utility's fair rate of return. While the fair rate of return is generally referred to as the cost of capital, there is a distinction between the two concepts. Strictly speaking, the cost of capital represents the mathematically calculated "price" that a utility must pay to raise debt and equity capital. The fair rate of return that is multiplied by the rate base may contain adjustments to the cost of capital that reflect management efficiency or other considerations related to the balancing of ratepayer and utility interests. The fair rate of return must strike a balance between the interests of ratepayers, who are entitled to the lowest reasonable cost of service, and the utility, which is entitled to an overall rate of return that allows it to attract capital on a reasonable basis.

In this case we have not been presented with any evidence that would lead us to adjust the cost of capital for any of these other factors affecting the broad public interest. Thus, we can and will use the terms "cost of capital" and "fair rate of return" interchangeably.

B. Overview of the Positions of the Parties³

Company witness Cogswell and Advocacy Staff (Staff) consultant LeLash have each presented recommendations regarding what allowed overall rate of return should be set in this proceeding. The cost of common equity and overall rate of return recommendations are summarized as follows:

| | Cost of Equity | Overall ROR |
|-----------------------|----------------|-------------|
| Cogswell (Company) | 14.00% | 11.40% |
| LeLash (Staff) | 11.25% | 9.63% |

We will discuss the capital structure ratios and the cost rates separately in subsequent sections.

C. Capital Structure

The first issue to be considered in setting a company's cost of capital is its capital structure. We determine a utility's capital structure prospectively, i.e., the structure that is most likely to be in place over the course of the rate effective period. If necessary, we replace a company's actual capital structure with a "hypothetical" capital structure if we find that the actual capital structure does not represent a reasonable balance between low cost and financial integrity.

There are two issues before the Commission concerning the Company's capital structure. First, should short-term debt be included as part of the Company's capital structure for the purpose of determining the overall cost of capital? Second, should the Commission take into account a "double leveraging" effect on the Company's capitalization?

³In this Order, the Commission's Advocacy Staff will be referred to as "Staff." Other Commission staff members, including the Examiners, are assigned to this case as advisors. The Advocacy Staff functions as a party to the case by presenting evidence and argument.

1. Short-Term Debt in the Capital Structure

The Staff and the Company proposed the adoption of identical capital structures except that the Staff recommended that short-term debt be included in the capital structure. The two witnesses' capital structures are presented in the following table:

| | Cogswell (Company) Position | LeLash (Staff) Position |
|-----------------|-----------------------------------|----------------------------|
| Long-term Debt | 39.86% | 38.65% |
| Short-term Debt | Not applicable | 3.05% |
| Common Equity | 60.14% | 58.30% |
| TOTAL | 100.00% | 100.00% |

The Company's cost of capital witness, Mr. Cogswell, used the Company's actual capital structure as of May 1994, excluding short-term debt. Mr. Cogswell did not include short-term debt in the Company's capital structure for three reasons: (1) short-term debt is not a part of the Company's permanent financing but will be replaced with permanent financing, either long-term debt or equity, as future capital expenditures occur; (2) the level of short-term debt is volatile and will vary considerably over time because it is used as an interim source of financing; and (3) short-term debt is routinely excluded by the investment community from capital structure analyses. The Company is also concerned that the level of short-term debt in the May 1994 capital structure, about \$165 million, is near the high point of the Company's short-term borrowing cycle.

The Staff's cost of capital witness, Mr. LeLash, also used the Company's actual capital structure as of May 1994 but, unlike Mr. Cogswell, he included short-term debt in his capital structure. Staff argued that: (1) short-term debt is in fact being used as a component of the Company's capital structure; and 2) short-term debt is a permanent source of interim financing and thus is an ongoing aspect of the Company's capital mix. While the level of short-term debt in the Company's capital structure varies from month to month, the Company has had an average monthly balance of about \$150 million during the first 9 months of 1994 in contrast to lower balances prior to April of 1993. Staff argued that because the Company chose to use

its capital structure as of May 1994, it is reasonable to also use the short-term debt level as of that same date.

Except for the dispute regarding the inclusion of short-term debt in the capital structure, there is no evidence that suggests that the Company's actual capital structure is unreasonable or that it does not strike an appropriate balance between low cost and financial integrity. The evidence shows that both the Company's and NYNEX Corp.'s common equity ratios are comparable to industry norms.

We agree with the Staff's analysis that short-term debt should be included in the capital structure, but we will use an amount of \$67.66 million rather than the \$164.57 million supported by Staff. The Company regularly uses short-term debt in its capital structure, which is taken into account by bond rating agencies. For each component of the capital structure except short-term debt, we will use the actual level as of May 31, 1994. For short-term debt, we will use the 36-month average short-term debt balance of \$67.76 million; the \$67.76 million debt balance is reasonably representative of recent experience and the likely level of short-term debt in the future. Our capital structure, set forth below, strikes a reasonable balance between providing a low-cost overall cost of capital and the need to provide a reasonable level of financial integrity.

| | Capital Structure Allowed in this Order |
|-----------------|--|
| Long-term Debt | 39.36% |
| Short-term Debt | 1.28% |
| Common Equity | 59.37% |
| TOTAL | 100.00% |

2. Double Leverage

Determining the overall cost of capital for a utility operating company that is owned by a holding company is a controversial capital structure issue. Two alternative views are often presented. On one hand, the "double leverage" concept prescribes the use of the parent company's overall cost of total capital as the measure of the cost of common equity to the operating subsidiary. Proponents of "double leverage" argue that intercorporate ownership by a parent company opens up the possibility of leveraging the common equity of one corporate entity at two or even

more corporate levels. Thus, if a parent corporation issues its own debt and if a wholly-owned subsidiary also builds debt over the base of equity invested by the parent, leveraging takes place twice on the single layer of the parent's publicly held equity -- thus creating "double leverage."

On the other hand, the divisional cost of capital view, also known as the "stand-alone" approach, is based on the principle that the operating utility division (or subsidiary) should be analyzed and treated in the usual way using the division's own capital structure and cost rates. If a division's capital structure is found to be unreasonable, a "hypothetical" capital structure would be constructed to correct this deficiency. The embedded costs of debt and preferred stock could also be evaluated for reasonableness, with adjustments made if needed. Because the parent would hold all or a portion of the "division's" common equity capital, the division normally would not be market-traded. To determine the division's cost of common equity, a comparable sample of market-traded utilities with comparable risk (perhaps including the parent) would be used as a "proxy" for the division's cost of equity. This methodology rests on the fundamental principle that the required return of a division depends on its risk, rather than on its parent's financing costs.

In this case, the Staff supported the "double leverage" view and the Company supported the "divisional cost of capital" view. Staff urged the Commission to consider, as Mr. LeLash has done, the effects of double leverage. While Staff did not use "double leverage" to lower the Company's stand-alone cost of capital of 9.63%, it was used to confirm the reasonableness of that 9.63% figure. Staff argued that the Commission should reaffirm the appropriateness of the double leverage concept for evaluating the Company's cost of capital. The Company noted that Mr. LeLash suggested that the Commission should make a double leverage adjustment only if it finds a cost of equity exceeding 12.50%.⁴ Company witness Cogswell responded that the "double leverage" approach should not be used because it is arbitrary, unnecessary and inappropriate.

We will not use the double leverage approach in this case because there is no evidence to suggest that: (1) the Company's actual capital structure is unreasonable; (2) NYNEX Corp.'s policies (such as its payout ratio policy) have been inappropriate; or, (3) that the capital structure does not strike an appropriate balance between low cost and financial integrity. Further, double leverage theory ignores competition among subsidiaries for capital from a parent company.

⁴Staff did not adopt this specific recommendation of its expert witness in their Brief.

Unless we determine that there is substantial evidence that the Company's capital structure is unreasonable, we will use the "divisional cost of capital" model to determine the Company's appropriate overall cost of capital. The divisional cost of capital approach is based on the principle that different subsidiaries of a parent company are exposed to different risks, as evidenced by the different bond ratings and debt costs. This same principle holds for equity investments as well; the cost of equity will vary between divisions of the same parent company, depending upon the risk profile of that division's operations. Using double leverage would inappropriately obscure this fact. We have thus evaluated the Company's capital structure using the divisional cost of capital approach.

D. Long-Term Debt

Generally, the cost of a utility's currently outstanding debt generates little dispute. That is the case here. In his testimony and exhibits, Mr. Cogswell provided a worksheet that shows that the Company's embedded cost of long-term debt was 7.48% as of May 1994. Staff's witness did not challenge Mr. Cogswell's calculation. We will adopt the 7.48% embedded cost of debt.

E. Short-Term Debt

Having included short-term debt in the Company's capitalization, we must consider what cost rate to establish for that debt. Because short-term debt is subject to a variable interest rate, Staff witness LeLash used a prospective rate of 6.00% versus the Company's historical rate average for 1993 and 1994 of 4.13%. While the Company's and NYNEX Corp.'s recent history supported a 5.00% cost rate, Mr. LeLash used a 6.00% rate because of a recent Federal Reserve action that had the effect of increasing the cost of short-term borrowing. Further, Mr. LeLash noted that, according to his summary of data published in the Blue Chip Financial Forecast, the cost of short-term debt is expected to peak at about 6.50% in 1995 and then to decline back to 5.30% by 1997.

On rebuttal, Company witness Cogswell argued that because short-term debt is eventually replaced with permanent equity or debt capital, the cost rate of short-term debt is equal to the overall cost of capital. The Company did not contest the derivation of LeLash's 6.00% estimate.

To identify the most economical source of short-term debt, we would normally base our estimate of the Company's cost of short-term debt on our analysis of the terms of the Company's sources of short-term debt, such as its lines of credit with banks. However, there is little evidence on these matters in the record. Because the Company's cost of short-term debt is likely to track the overall cost of commercial paper, we find that the 6.00% short-term debt estimate used by Mr. LeLash provides

an acceptable proxy for the Company's likely experience. We will therefore adopt 6.00% as our estimate of the cost of short-term debt.

F. Common Equity

The positions of the parties on the allowed cost of equity vary by a total of 275 basis points. Company witness Cogswell recommended a cost of common equity of 14.00% while the Advocacy Staff's witness, Mr. LeLash, recommended a cost of common equity of 11.25%. The cost of equity determination has two components.

First, the "bare-bones" cost of equity must be determined. This is a multi-step process:

- Because the Company is not market traded, comparable samples must be identified. Each of the witnesses employed a group of comparable companies in completing his discounted cash flow (DCF) analysis. NYNEX Corp., the parent of the Company, was, to a greater or less extent, included in the group of "comparable" companies used by each analyst.
- As discussed in detail below, each party's witness used some form of the Discounted Cash Flow (DCF) analysis as one method of arriving at the recommended cost of equity allowance. The DCF method requires three financial components to calculate the cost of equity: a dividend, a stock price and a growth rate. The dividend divided by the stock price is generally referred to as the dividend yield, to which the growth rate is added in order to arrive at the "bare bones" cost of capital.
- In addition, each witness used (in varying degrees) some type of risk-premium approach -- such as the Capital Asset Pricing Model (CAPM) -- to corroborate the DCF findings.

Second, once the "bare-bones" cost of equity has been determined, the Commission must determine whether to allow the recovery of "issuance costs." If allowed, then the amount of issuance costs must be determined. While Mr. Cogswell argued that a 27 basis point "addier" for issuance costs is required, Mr. LeLash argued that no issuance cost adder is needed.

We will sequentially consider each of the steps in our discussion below. We will first review the Company's positions on each issue, then the Staff's. Then we will analyze the parties' positions and determine the appropriate cost of common equity for the Company.

1. The Company's Position

Company witness Cogswell recommended 14.00%, the high end of his 13.00% to 14.00% cost of equity range. Mr. Cogswell arrived at his cost of equity range and recommendation through the use of three methods: (1) DCF analysis; (2) risk-premium analysis (including CAPM); and (3) the comparable earnings approach. In developing his recommendation to use the high end of his range, Mr. Cogswell emphasized the increasing business risk in telecommunications, the inappropriateness of DCF analysis of the Regional Bell Holding Companies (RBHCs), and increasing interest rates (at the time his testimony was filed in October 1994).

a. Comparable Samples

Mr. Cogswell applied his cost of equity methods to three different comparable samples. First, Mr. Cogswell developed a "13 LEC Parent" group, including NYNEX Corp., which consists of 13 local exchange carrier (LEC) companies that have rated debt and where LEC operations account for a major portion of revenues. Second, Mr. Cogswell used a "High Grade Industrial Group," which consists of Value Line companies with AAA to AA- bond ratings that have been screened to eliminate all high beta companies. Third, Mr. Cogswell used a "Beta Group" consisting of 96 non-LEC, non-utility, non-financial, domestic corporations with betas of .85 to .90 (these betas are similar to the LEC Parent Group's Value Line beta of 0.86). Mr. Cogswell viewed the latter two of these three groups as alternative investment opportunities for investors.

b. DCF Analysis

Based on his DCF analysis, using a simplified annual DCF model, Mr. Cogswell found a cost of equity of 13.40% for the High Grade Industrial Group, 12.96% for the Beta Group, and 12.47% for the LEC Parent Group.

Mr. Cogswell did not include a DCF analysis of NYNEX Corp. alone because he believes that the traditional DCF analysis based on the market price and return expectations for NYNEX Corp. or any other individual RBHC provides an inappropriate estimate of the Company's cost of equity. He believes that this is the case because of expectations of high earnings in the future due to: 1) cellular, non-regulated and foreign enterprises; 2) relaxing or lifting the Modified Final Judgment (MFJ) and cable TV cross-ownership restrictions; and 3) improved performance by telco subsidiaries as a result of incentive regulation, improved productivity and new

technologies. Mr. Cogswell testified that the "constant growth expectation" of the simple, one stage, DCF model is not valid because of expectations of higher long-term growth for NYNEX Corp. and the RBHCs. In essence, expectations of a higher current earnings raises the stock price, thus lowering the dividend yield portion of the DCF formula. Further, the 5-year Institutional Brokers Estimate System (I/B/E/S) growth rate estimate does not fully incorporate long-term growth expectations. For this reason, Mr. Cogswell used the LEC Parent Group primarily as a check on his results.

In calculating the expected dividend rate, Mr. Cogswell increased the current indicated dividend by one-half of the growth rate expectation, thus assuming that, on average, the companies will pay the current quarterly rate for two quarters and the new, increased rate for the remaining two quarters of the year. Mr. Cogswell noted that he failed to use a model that reflects that dividends are paid quarterly; he therefore believed that the results of his DCF analysis are conservative. To incorporate recent market information while avoiding the possibility of short-term stock price aberrations, Mr. Cogswell examined stock prices over a 6-month period (March through August 1994).

To estimate the expected growth rate, Mr. Cogswell relied upon data summarized by the I/B/E/S. He noted that I/B/E/S provides a convenient and direct measure of the consensus forecast of financial analysts and that the future expected growth rate for any particular security is best estimated by the I/B/E/S figure.

On rebuttal, Mr. Cogswell presented additional arguments supporting his view that the current growth rate estimates do not reflect the RBHC's long-term growth potential. Mr. Cogswell further argued that a single-stage DCF model will understate the cost of equity for the RBHCs, and proposed instead a 3-stage DCF model that showed a return on equity requirement of 13.20% for Mr. LeLash's group of five RBHCs, 13.40% for Mr. Cogswell's 13 LEC Parent Group, and 12.50% for NYNEX Corp. and Pacific Telesis as individual companies.

c. Risk-Premium Analyses

In addition to the DCF model, Mr. Cogswell used the risk-premium analysis (including the Capital Asset Pricing Model). Mr. Cogswell performed three analyses:

- a "comparable group DCF risk premium" method that results in an average required ROE of 14.77%;

- an "Ibbotson-Sinquefield Risk Premium/CAPM method" that results in an average required ROE of 13.53%; and
- a "capital market line (CAPM) method" for the Value Line companies that results in an average required ROE of 12.84%.

For his "risk premium" analysis, Mr. Cogswell used a risk-free rate of 7.34%, based on the average of long-term government bonds for March-August 1994.

In his "comparable group DCF risk premium" method, Mr. Cogswell developed a "risk premium" for his "beta group" -- a group of companies followed by Value Line with betas similar to the LEC parents. Mr. Cogswell used the DCF method to calculate expected return for each company in his sample (using I/B/E/S growth rates). He then developed a risk premium by comparing this expected return with the yield long-term Government bonds (as measured over the last 6 months of 1993). Five years of risk premiums were calculated in this manner. This analysis produced a risk premium of 7.43% and a required equity return of 14.77%.

In his "Ibbotson-Sinquefield Risk Premium CAPM" method, Mr. Cogswell used the 7.20% equity risk premium for the S&P Composite Stock Index (S&P 500) over long-term Government bonds for the 1926-1993 period. This 7.20% risk premium is adjusted to reflect the relative risk by multiplying by 0.86 (the unweighted average Value Line beta of the LEC Parent Group). For the LEC Parent Group, this results in a risk premium of 6.19% and a required equity return of 13.53%.

In his "capital line method," Mr. Cogswell used the DCF model to measure the expected return for each company in the Value Line Composite Index that pays dividends. Using the LEC Parent beta of 0.86, the required equity return is 12.84%.

d. Comparable Earnings Analyses

Mr. Cogswell also performed a "comparable earnings" analysis. Based on his comparable earnings analysis, Mr. Cogswell found that historical 5-year ROEs range from:

- 11.91% for the Beta Group;

- 17.07% for the High Grade Industrial Group;⁵
- 12.78% for the LEC Parent Group.

e. Flotation Costs

According to Mr. Cogswell, there are two general categories of flotation costs. First, Mr. Cogswell believes that issuance costs, which include such items as underwriters' commissions, legal fees, and printing fees, generally comprise between 4.00% and 5.00% of the proceeds of an issue. Second, Mr. Cogswell urged recognition of market pressure costs, a decline in price associated with the sudden increase in supply of shares resulting from the sale of shares to the public, which he estimated to total 2.00% to 3.00%. Based on these factors, Mr. Cogswell developed a 5.00% flotation cost allowance, which he believes is a conservative estimate of these costs. Mr. Cogswell adjusted his "bare-bones" cost of equity results using the following formula:

$$K_e = \frac{D_o (1+g/2)}{P_o(1-f)} + g$$

Where:

| | | |
|-------|---|--|
| K_e | = | the required rate of return on common equity; |
| D_o | = | the current annual dividend; |
| P_o | = | the current market price; |
| f | = | flotation cost allowance; |
| $g/2$ | = | 1/2 the expected annual growth rate in dividends |

2. The Advocacy Staff's Position

Mr. LeLash recommended the low end, 11.25%, of his 11.25% to 12.25% cost of equity range. Mr. LeLash arrived at his cost of equity range and recommendation through the use of the DCF and CAPM models, although he used the CAPM only as a check on his DCF model. In recommending the low end of his cost of equity range, Mr. LeLash emphasized that the Company was most comparable to NYNEX Corp. and Pacific Telesis, whose cost of equity he estimated at about 11.25%. He further argued that this 11.25% cost of equity was based on current market conditions, forecasts of prospective interest rates (at the time he did his analysis) and the pricing of equity capital in the marketplace.

⁵Mr. Cogswell eliminated twelve AAA rated industrial companies from this sample.

a. Comparable Samples

Mr. LeLash applied his cost of equity analysis to three different comparable samples. He used:

- NYNEX Corp.;
- Pacific Telesis, which has been a relatively "pure play" telephone company since spinning off its cellular operations in April 1994; and
- an RBHC composite, which contains the five remaining RBHCs (Ameritech, Bell Atlantic, BellSouth, SBC Communications (formerly known as Southwestern Bell Corporation) and U.S. West).

Mr. LeLash acknowledged that the RBHC composite may not provide a fully comparable proxy for the Company but that its use will give the Commission a range of reasonableness regarding the Company's cost of equity.

Mr. LeLash analyzed the risks of NYNEX Corp., Pacific Telesis and the other RBHCs. Based on his analysis, Mr. LeLash asserted that the financial data show that NYNEX Corp.'s financial measures are generally comparable to those of his RBHC sample. While NYNEX Corp.'s market-to-book ratio and earned ROE are below that of the RBHC sample, Mr. LeLash believes that NYNEX Corp.'s payout ratio is roughly consistent with that of the RBHC sample. Based on his review of various financial and operational statistics, the RBHC sample and Pacific Telesis define the boundaries of the risk levels of the Company and NYNEX Corp.

b. DCF Analysis

Using a simple annual DCF model, Mr. LeLash found a cost of equity of 12.21% for his RBHC sample, 11.21% for his Pacific Telesis sample, and 11.30% for his NYNEX Corp. sample. Based primarily on these results, Mr. LeLash developed his recommended range of 11.25% to 12.25% and his recommended point estimate of 11.25%.

To calculate the dividend rate for use in a DCF analysis, Mr. LeLash adjusted the current dividend (reflecting the current actual annual dividend rate) to develop the dividend that is expected during the next year, which he defined as the current dividend times 1 plus 1/2 the growth rate.

For the stock price used in his calculation, Mr. LeLash used the average stock price during the most recent quarter. The 3-month average stock price avoids aberrations that may be present in spot data and is a sufficiently long period of price history to ensure that any underlying market interest rate trend is captured in the analysis.

Mr. LeLash argued that there is no single measure that can be used to estimate the growth rate for use in a DCF analysis. Rather, he used several different approaches, including a "br" or internal growth estimate, historical growth data, and expected growth rate data as presented by Value Line and the I/B/E/S. After reviewing his entire growth rate analysis, Mr. LeLash used the I/B/E/S median 5-year growth rate in earnings to determine the cost of common equity of each of his sample groups.

For his RBHC composite, Mr. LeLash developed a dividend yield of 5.11% and a 7.10% growth rate, which produced a 12.21% cost of equity estimate. For his Pacific Telesis sample, Mr. LeLash developed a dividend yield of 7.21% and a 4.00% growth rate, which produced an 11.21% cost of equity estimate. For his NYNEX Corp. sample, Mr. LeLash developed a dividend yield of 6.30% and a 5.00% growth rate, which produced an 11.30% cost of equity estimate.

c. Risk-Premium Analyses

In addition to the DCF model, Mr. LeLash used a CAPM approach to "confirm" the cost of equity estimates that he developed in his DCF analysis. The CAPM methodology requires estimates of the "risk-free" rate, the "risk-premium" over the "risk-free rate" and the "beta" (which can be used to estimate a security's risk). Mr. LeLash used a 5-year interest rate forecast of 7.50% for the 30-year treasury bond. For his "risk-premium," Mr. LeLash developed a risk-premium range of 3.70% to 6.70% based on 10-, 20- and 30-year risk premiums (during the period 1964 to 1993). Multiplying these risk-premiums times beta and adding the risk-free rate provided CAPM returns of between 10.50% and 12.90%. According to Mr. LeLash, these CAPM cost of equity estimates are consistent with his recommended 11.25% common equity return. Mr. LeLash cautioned the Commission, however, not to place great weight on his CAPM analysis as he intended it only to be a "confirmation" of his DCF results.

d. Comparable Earnings Analyses

Mr. LeLash also performed a "comparable earnings" analysis. Mr. LeLash reviewed "comparable earnings" for industrial companies for the limited purpose of determining the average earned ROE of industrial companies. Mr. LeLash argued that since utilities are less risky than industrials, as indicated by the fact that utility betas are generally less than one, a review of industrial's earned ROE provides an indication of the high-end of a range of reasonableness regarding prospective equity capital costs. Mr. LeLash found that industrial composites earned, on average, 12.10% on equity during the 1989 to 1993 period. Further, the "implicit" DCF of the companies followed by Value Line yields a range of 10.41% to 14.97%, with a midpoint of 12.69%.

Finally, Mr. LeLash reviewed trends in the allowed cost of equity granted by other state utility commissions. He found that the allowed returns on equity by other state regulatory commissions have averaged about 11.00% to 11.50% for electric and gas utilities since the third quarter of 1993. For telephone utilities, the allowed cost of equity has averaged about 11.50%.

e. Flotation Costs

Staff in its Brief asserts that a flotation cost adjustment is "speculative at best." Staff witness LeLash argued that Company witness Cogswell's 5.00% adjustment to account for flotation costs is unreasonable. According to Mr. LeLash: (1) common equity holders have already accounted for flotation costs in establishing the current price of stock and therefore no further adjustment is needed; (2) if the issuing company can market its stock at prices above book value on a net proceeds basis, which NYNEX Corp. can, no flotation adjustment is needed; (3) there is no empirical evidence in the finance literature to support a "market pressure" adjustment; (4) flotation costs are not "known and definite;" and (5) the Company has not identified any planned common equity issuances in the future.

3. Discussion and Analysis of Allowed Cost of Equity

After considering all of the evidence, we find that the allowed return on common equity for the Company shall be set at 12.50%. As has been our practice for many years, we rely mainly on the results of a DCF analysis.

a. Comparable Samples

We will rely primarily on the RBHC companies as our comparable sample. This, in essence, is Staff consultant LeLash's position. While Mr. LeLash argued that the results for NYNEX Corp. and Pacific Telesis are the most

comparable to the Company, he used the other five RBHCs to develop his estimate of the high end of the reasonable range.

Of the three comparable samples that Mr. Cogswell developed, we believe that his 13 LEC Parent Group, which consists of 13 local exchange carrier (LEC) companies, including NYNEX Corp., that have rated debt and where LEC operations account for a major portion of revenues, is the most appropriate of his comparable samples. We are concerned, however, that the non-RBHC LECs are more heavily engaged in businesses that are quite dissimilar to that of the Company. For that reason, we will not rely extensively on Mr. Cogswell's 13 LEC Parent Group but will consider these results as a check to the reasonableness of the RBHC results. We find that Mr. Cogswell's High Grade Industrial and Beta Groups are too uncertain in their relationship to the risks that the Company faces that they cannot be given substantial weight in our analysis.

b. DCF Analysis

The DCF method requires three financial components to calculate the cost of equity: a dividend, a stock price and a growth rate. The dividend divided by the stock price is generally referred to as the dividend yield, to which the growth rate is added in order to arrive at the "bare bones" cost of capital. Both cost of equity witnesses used a simple (single-stage) annual DCF model in their direct testimony. We will do the same here, although we agree with Mr. Cogswell that the results developed through a simple annual DCF model are conservative because the model fails to reflect the quarterly payment of dividends.

While we do not completely discount the use of a multi-stage model, Mr. Cogswell has not persuaded us that its use is required in this proceeding. The DCF can be used with any number of "stages," but we do not have an adequate multi-stage DCF model because there is limited data available regarding long-term growth rates. Although we will not use a multi-stage DCF model in this case, we remain aware of the limitations of the DCF model that we are using as well as the inputs into that model.

Both Mr. Cogswell and Mr. LeLash adjusted the current dividend (reflecting the current actual annual dividend rate) to develop the dividend that is expected during the next year, which they both defined as the current dividend times 1 plus 1/2 the growth rate. We believe that this is reasonable, and even conservative, and we will therefore follow this approach.

Mr. LeLash used the average stock price during the most recent quarter as the most reasonable stock price measure. Mr. Cogswell used a 6-month average stock price. Of the two approaches, the 3-month average stock price is

preferable because it will reduce the likelihood of short-term aberrations that may be present in spot data while not being so long as to introduce overly outdated and therefore irrelevant data into the DCF analysis. Therefore, we will rely upon the stock prices developed by Mr. LeLash.

Both Mr. Cogswell and Mr. LeLash relied heavily upon I/B/E/S 5-year growth rate data. We agree with the cost of equity witnesses that I/B/E/S provides a useful, convenient and direct measure of the consensus forecast of financial analysts. We will therefore use the I/B/E/S median 5-year growth rate, as presented by Mr. LeLash, to estimate the expected growth rate.

The following table summarizes the DCF results for Mr. LeLash's NYNEX Corp., Pacific Telesis and his 5-RBHC sample. Also included are the results for the non-NYNEX Corp. RBHCs and an average of the RBHCs.

| Company | Expected Dividend Yield | Estimated Growth Rate | DCF Estimate |
|--|-------------------------|-----------------------|--------------|
| NYNEX Corp. | 6.30% | 5.00% | 11.30% |
| Pacific Telesis | 7.21% | 4.00% | 11.21% |
| Five RBHC sample ⁶ | 5.11% | 7.10% | 12.21% |
| Non-NYNEX Corp. six RBHC sample ⁷ | 5.46% | 6.59% | 12.05% |
| Seven RBHC sample ⁸ | 5.58% | 6.36% | 11.94% |

⁶Excludes NYNEX Corp. and Pacific Telesis.

⁷Excludes NYNEX Corp.

⁸This row of figures was calculated as a weighted average of the 5-RBHC sample (5/7ths); Pacific Telesis (1/7th); and NYNEX Corp. (1/7th) DCF estimates. The 6-RBHC sample uses a similar approach. Mr. LeLash failed to present the dividend rate and stock price data of each of his five RBHCs in his testimony or exhibits, although he did present the growth rates for each of these RBHCs.

c. Risk-Premium Methodologies

The witnesses also used risk-premium methodologies in arriving at their final recommendations. Mr. Cogswell's risk-premium analyses produced results that ranged from 12.84% to 14.77%. Mr. LeLash's risk-premium analysis produced results that ranged from 10.50% and 12.90%, with a midpoint of 11.70%. Thus, the risk-premium analyses produced results that ranged, overall, from 10.50% to 14.77%.

Of the two cost of capital witnesses, we are more comfortable with Staff witness LeLash's analysis. In his CAPM analysis, Mr. LeLash used: (1) a 7.5% estimate of the "risk-free" rate, which is in line with the 5-year interest rate forecast for 30-year Treasury bonds; (2) NYNEX Corp.'s beta of 0.80; and (3) 10-, 20- and 30-year historical risk-premiums. We have little dispute with any of the inputs that Mr. LeLash selected and therefore view his CAPM midpoint of 11.70% as an appropriate confirmation of our DCF results.

While Mr. Cogswell used his risk-premium methods as his primary cost of equity analysis, we have less confidence in them. Generally, Mr. Cogswell's explanation of his approaches, in his direct testimony, is unpersuasive. For example, it is not clear what inputs he used to derive his "comparable group" DCF analysis, and, more fundamentally, it is unclear why a DCF analysis of industrials, over the last 5 years, is a useful way to estimate the Company's forward-looking cost of equity capital. While Mr. Cogswell's use of the average LEC beta of 0.86 is a plausible proxy for the Company's beta, we note the sensitivity of CAPM to the beta used; if, for example, he had used NYNEX Corp.'s beta of 0.80, his estimate would have been 43 basis points lower. The basis for his choice of inputs used to derive his "capital market line" calculations is also unclear. On balance, we cannot place significant weight on Mr. Cogswell's risk-premium results.

d. Comparable Earnings Analyses

Based on his comparable earnings analyses, Mr. Cogswell produced results that ranged from 11.91% to 17.07% while Mr. LeLash produced results that ranged from 10.41% to 14.97%. Thus, the comparable earnings analyses produced results that ranged, overall, from 10.41% to 17.07%, a wide range indeed. Essentially, we found these presentations of limited value; while they provided some interesting background information, the presentations are not a factor in our determination of the Company's cost of common equity and therefore we will not extensively analyze their methods.

e. "Bare-Bones" DCF Analysis

We agree with Staff that a "bare-bones" cost of equity range of 11.25% to 12.25% is appropriate for the Company, but we are not convinced that the lowest point on that range, 11.25%, should be given great weight. Rather, we believe that the high end of the "bare-bones" cost of equity range, 12.25%, is the best estimate of the Company's bare-bones cost of equity capital. In essence, this estimate is based on the results of Mr. LeLash's 5-RBHC sample.

We believe that 12.25% is an appropriate estimate of the Company's "bare-bones" cost of common equity for a number of reasons. First, we are not convinced that NYNEX Corp. is less risky than the other RBHCs. A firm's risk can be separated into two categories, financial risk and business risk. Mr. LeLash's Schedule 3 indicates that NYNEX Corp. compares unfavorably with the other RBHCs in its financial risk because of: (1) lower equity ratio; (2) lower fixed-charge coverage percentage; (3) lower internal cash flow; (4) lower net profit margin; (5) lower five-year growth rate; (6) lower return on total capital. NYNEX Corp. also has a higher payout ratio. Despite these weaker financial ratios, Mr. LeLash asserted that NYNEX Corp. was less risky because it had a higher percentage of telephone operations. This conclusion appears to be overly simplistic. The conclusion may have been based on erroneous data (from C.A. Turner) and in any event the level of diversification, in itself, is not an adequate measure of a firm's riskiness. On balance, we find that NYNEX Corp.'s financial risk is at least equal to that of the other RBHCs.

Second, the local exchange operations of NYNEX Corp., including the Company, face increasing competition from interexchange carriers, competitive access providers, cable TV operators, and others. As a result, we find that NYNEX Corp.'s business risk is increasing and appears to be roughly comparable to the other RBHCs. This finding is supported by the evidence presented by Mr. Cogswell. Because of this level of financial and business risk, NYNEX Corp.'s DCF results, which produce lower results than all but one of the other RBHCs, appear to be misleading.

Third, there are some practical limitations to the single-stage DCF analysis that should not be ignored. The 5-year median DCF growth rate, for example, may not fully reflect the long-term growth potential of the telecommunications industry, and thus may artificially lower the DCF results. While we are not convinced that this factor is so important that it precludes our use of a single-stage DCF analysis, it is a compelling reason to reject selecting the lowest point on the reasonable range as our best estimate of the Company's cost of common equity.

Fourth, we acknowledge that regulated utilities do not bear all of the risks that the non-regulated operations of an RBHC would bear and therefore these operations require a lower rate of return. On the other hand, the local exchange

telephone companies, like the Company, will be facing increased business risk in the future. For example, the Company will bear increased risk under an Alternative Form of Regulation (AFOR) plan. We believe that it is important to recognize the changing risk profile for the Company under an AFOR plan. Under an AFOR plan, we must allow the Company a return on equity that is reasonably consistent with the Company's current and prospective financial and business risk.

For all of the reasons discussed above, 12.25% is our best estimate of the Company's "bare-bones" cost of equity.

f. Flotation Costs

Consistent with our prior practice, we conclude that an increment for issuance costs is necessary, and we will allow the recovery of these costs. We will not provide an increment for "market pressure" related costs.

When a company raises common equity capital, it experiences costs of issuances including an underwriting fee as well as legal, accounting, printing, and other out-of-pocket costs. Although the Company does not issue common stock directly to the public, the Company's parent company, NYNEX Corp., does make public issuances of common stock. Because NYNEX Corp. raises capital for the benefit of its subsidiaries or divisions, the subsidiaries, including the Company, should each bear a portion of the associated issuance costs.

Issuance costs must be recovered through the ratemaking process, either as a one-time expense or through an ongoing rate of return increment. Without explicit recognition of prudent and reasonable issuance costs, neither existing nor potential investors would have an opportunity to earn a fair and reasonable return on common equity.

If we allowed issuance costs to be reflected in the revenue requirement as a one-time expense, issuance costs would be recovered as common stock issuances occur. There would be no recovery required during periods of no common stock issuances. On the other hand, if issuance costs are not reflected in the revenue requirement as a one-time expense, a rate of return increment is required because issuance costs would then represent foregone capital. Because a rate of return increment is an ongoing requirement, the actual timing of issuances has no bearing on the need for a rate of return increment, and it is required even if there are no recent issuances or plans for future issuances. Because the Company has not been allowed to recover issuance costs as a one-time expense, a rate of return increment is necessary, regardless of the timing of both recent and projected issuances.

We will use the approach, discussed by Mr. Cogswell, that applies the issuance cost increment to the current market price within the framework of the DCF model. In other words, the "stock price" is reduced by the issuance cost increment to determine the net proceeds per share under current market conditions. By holding all other DCF variables constant, the DCF estimates that include this adjustment will be higher than the DCF result without adjustment. The difference between the two DCF results represents the appropriate issuance cost increment.

We have no evidence of NYNEX Corp.'s actual issuance cost experience, so we have relied upon the low end of Mr. Cogswell's 4.00% to 5.00% estimate. Because NYNEX Corp. has a yield of 6.30%, a 4.00% issuance cost adjustment results in a 26 basis point issuance cost increment $[(6.30\%/0.96) - 6.30\%]$. An issuance cost increment of 25 basis points will be added to our 12.25% "bare-bones" DCF estimate to derive our "all-in" cost of common equity of about 12.50%.

Nothing in the record of this case has persuaded us that a market pressure adjustment is needed. Therefore, we will continue our policy of not including a market pressure adjustment.

4. Cost of Capital Summary

Based on the findings and discussion contained in this section, the cost of capital for the Company is 10.44%, computed as follows:

| Component | % of Capital | Cost Rates | Weighted Cost Rates |
|-----------------|--------------|------------|---------------------|
| Long-Term Debt | 39.36% | 7.48% | 2.94% |
| Short-Term Debt | 1.28% | 6.00% | 0.08% |
| Common Stock | 59.37% | 12.50% | 7.42% |
| TOTAL | 100.0% | | 10.44% |

We find that our overall rate of return, 10.44% is reasonable. This overall rate of return will provide the Company with the opportunity to earn a fair rate of return on its Maine jurisdictional operations.

III. RATE BASE ADJUSTMENTS

In this section, we will address those issues that have only rate base effects. Two adjustments to test year rate base were accepted by the parties: elimination of contractor retention from the cash working capital lead-lag study and reduction of rate base for deferred taxes and uncollectible reserves. They will not be further discussed.

A. Stranded Copper Investment

OPA and American Association of Retired Persons (AARP) witness Weiss proposed large adjustments to NYNEX's rate base and expenses to account for "stranded" investment in copper loop facilities and excess fiber optic capacity in interoffice (I.O.) facilities. NYNEX placed fiber optic cable in the feeder portion of its loop plant and in its I.O. plant to supply capacity that was needed for growth. Even the smallest fiber optic cables have enormous capacity. For example, a minimum-size 6-strand cable can provide over 2,000 loop circuits. As a result, some of NYNEX's existing investment in copper plant became "stranded." The OPA and AARP have proposed to disallow the cost of all excess capacity for ratemaking purposes. Specifically, they recommend that the Commission remove from NYNEX's intrastate rate base: 1) \$93.684 million of gross plant investment; 2) \$46.4 million of accrued depreciation reserve; and 3) \$12.873 million of accumulated deferred income taxes. The OPA and AARP also proposed three related adjustments that would remove from the test year operating income statement: 1) \$6.386 million of depreciation expense; 2) \$7.921 million of maintenance and corporate operations expense; and 3) \$1.941 million of operating taxes.

To make his adjustment, Mr. Weiss, developed a computer model of NYNEX's Maine loop network to determine the magnitude of any excess loop investment in NYNEX's Maine territory. The first step in the model was to determine the total number of cable pairs actually spliced through to the field from the Main Distribution Frames (MDFs) of each NYNEX-Maine wire center. Then he used access line forecasts provided by NYNEX to compute the compound rate of growth in access line demand for each of NYNEX's Maine wire centers for the past five years. From that compound growth rate he developed preliminary growth margin for each NYNEX Maine wire center using an economic engineering interval of 4 years. Mr. Weiss then added an additional margin of 25% to determine the total capacity margin for each wire center.

Mr. Weiss' model then calculated the maximum loop pair capacity needed for each wire center by multiplying the number of pairs estimated to be in use as of December 1994 by the total capacity margin for each wire center plus 100%. The maximum loop capacity was then rounded to the next higher 100 pairs, resulting in the maximum reasonable loop capacity for each of NYNEX's wire centers in Maine.

Mr. Weiss' model then compared what he calculated to be the maximum needed loop capacity for each wire center with the total installed loop capacity that extends into the distribution portion of the loop network. He deemed to be stranded any installed loop capacity which exceeded the loop capacity he calculated as needed for each wire center.

To determine NYNEX's net investment and operating expenses associated with what he considered to be the stranded copper loop capacity, Mr. Weiss calculated the average embedded costs for one local loop using the Maine-specific FCC Part 36 jurisdictional separations reports for the 12 months ended July 31, 1994. He multiplied what he considered to be stranded loops to yield his recommended adjustment.

Mr. Weiss' methodology was subject to considerable dispute and debate including, but not limited to, the correct economic intervals for loop plant investment, the reasonable margin of spare capacity, and whether Mr. Weiss' model correctly reflected the stretch increments in which cable is manufactured. Because, for the reasons stated below, we did not make any adjustment to rate base, it is not necessary for us to discuss or resolve those disputes here.

Staff witnesses Cowie and R. Gabel also argued that NYNEX has significant excess capacity in loop and interoffice facilities but proposed to correct for that excess capacity by increasing the productivity factor of the price cap formula instead of making a rate base adjustment. Staff's suggestion is apparently grounded in the belief that the short-run marginal costs for services using already-installed network functions and capacity approaches zero. Thus, any new revenue will increase the Company's output without any increase in input. The Staff's analysis, as further described in Section III.A.4.c and III.C.4.b of our Order in Docket No. 94-123, was helpful in understanding the nature of the new network and in reaching our conclusion about the implications of that structure.

Both OPA and Staff have made after-the-fact examinations of the number of excess loop and I.O. facilities that have become unused because new technologies were used to provide those network functions. No party, however, offered evidence to demonstrate that any of NYNEX's copper fiber or multiplexer investment had been made imprudently. Mr. Weiss appears to assume that the existence of excess capacity alone would justify a disallowance even without proof of imprudence. Mr.

Weiss stated that he conducted no analysis as to whether the fiber cable was placed in a prudent manner. His entire theory for an adjustment was that some capacity was not currently "used and useful." Staff witnesses R. Gabel and Cowie also appear to make such an assumption by virtue of their secondary recommendation of a possible rate base disallowance.

OPA claims that there is legal authority for the Commission to exclude from rate base property that is neither used nor useful. The case cited by the OPA does not, however, support its position. In that case the Commission ruled that it was not precluded from including canceled plant in rate base. Central Maine Power Company, Proposed Increase in Rates, Docket No. 81-127. Order at 28 (Mar. 27, 1982). The Law Court had previously upheld this interpretation. Central Maine Power Co. v. Public Utilities Commission, 433 A.2d 331 (Me. 1981). The Public Advocate also cited 35-A M.R.S.A. § 303 in support of its argument that we have discretion to adopt the "used and useful" standard. Section 303, however, does not create a "used and useful" standard for the exclusion of items from rate base, but rather requires inclusion in rate base of property that is used to provide service. *Id.* at 350. Even if we do have discretion to exclude plant from rate base because it is not used, we have never adopted a policy under which we would disallow a plant solely because it was not used and useful, and the Public Advocate has not provided us with a persuasive policy argument in this case why we should. One reason against adopting that standard is it would send the wrong signals to those we regulate. A regulated company might choose not to deploy cost-effective technologies if we did not allow recovery of prudently invested in-place facilities that become stranded by the new technologies.

The OPA argues in the alternative that the stranded copper investment should be considered "property held for future use" and should be excluded from rate base because NYNEX has no definite plans to use it. OPA cites a Central Maine Power case in which the Commission required a definite plan before including property in rate base that was held for future use to avoid burdening ratepayers "for an indefinite period with paying a return on company assets which confer no immediate benefit on and provide no guarantee or future guarantee of benefit to Central Maine's ratepayers." Central Maine Power Company, FC Nos. 2332, 2336, 26 PUR 4th 388, 400 (Me. P.U.C. 1978). That case, however, dealt with a far different situation than the one that is involved here. There the excluded investment was land that had never been or may never be used to provide utility service. Here the OPA is asking that we exclude investment that was prudently made, that has been used and needed to provide utility service, and that became "stranded" because of a further investment that was also prudent.

In this case, we must decide whether NYNEX's investment in fiber optic facilities was prudently incurred. In other words "whether the utility followed a course

of conduct that a capably managed utility would have followed in light of existing and reasonably knowable circumstances." Maine Public Utilities Commission, Investigation of Seabrook Involvement by Maine Utilities, Docket No. 84-113 (Order Phase II) (May 28, 1985) at 12. Nothing in the record of this case demonstrates that NYNEX did not act prudently when it invested in any of its existing copper or fiber optic facilities. We will therefore not make any of the adjustments to rate base or expenses proposed by the OPA. We have addressed Staff's proposal concerning the productivity factor in our order in Docket No. 94-123.

Even if a finding of imprudence were possible, we note that other aspects of the OPA's analysis contain serious flaws that might preclude applicability in this case. First, the OPA's aggregate analysis assumes that loops are fungible assets that can be moved, at will, to serve different areas of an exchange. That assumption is erroneous. Loop plant is a classic example of a location-specific facility that must be in place at a specific location to serve the needs of subscribers in that area. In most cases, spare facilities in one area of an exchange are of little or no use when the need for service is in another area.

Second, the OPA's proposed method of determining the value of any overcapacity is seriously flawed. The OPA proposed a disallowance based on a ratio of unused to total plant, applied to the average embedded costs of all loop and I.O. investment. Using average embedded costs for calculating any proposed disallowance significantly overstates the actual incremental difference in cost for systems of different capacities because significant economies of scale exist for the installed cost of both copper and fiber facilities.⁹ The OPA's proposed method also overstates the incremental cost of fiber facilities because the optical converters and multiplexors used with the fiber are modular. Thus, capacity in those facilities only needs to be installed on an as-needed basis. Therefore, unused fiber facilities have much lower total costs than used fiber facilities.

⁹The disallowance proposed by OPA witnesses would be poor public policy. Under the Weiss proposal, if a manager wanted to invest an additional \$1 million in the infrastructure, with the potential to generate an additional \$2 million in revenues, he might be faced with a \$5 million reduction in allowed revenues if it happened that his \$1 million investment created substantial amounts of spare capacity in the network. This approach is unacceptable. The enormous disincentive to find more efficient ways of providing telecommunications services that would be created by adopting the Weiss proposal is fundamentally inconsistent with NYNEX's franchise obligation to develop and deploy a first-rate telecommunications infrastructure for Maine that has the ability to continue to connect Maine's residents -- and businesses -- to the world markets.

The OPA, the Advocacy Staff and AARP have placed great emphasis on ascertaining NYNEX's possible motives for building excess capacity, particularly in fiber optic facilities. Staff, OPA, and AARP appear to believe that the possibility that NYNEX can use its fiber investment to provide "video dial tone" or other cable TV-like services is itself a reason to disallow some of it. NYNEX presented testimony, through Mr. Helgeson, to establish that all of its present facilities were deployed in an amount and in such a manner that were most efficient for providing telephone service. In addition, however, NYNEX also appeared to claim that it had no plans for its presently unused fiber optic capacity. NYNEX even attempted to deny the obvious fact that some "dark fiber" can be used for cable TV-like services. Staff's argument that NYNEX should not be installing a broad band infrastructure if it has no plan to use that infrastructure to offer service that will generate revenues is well taken. NYNEX perhaps "doth protest too much." Nevertheless, Mr. Helgeson's testimony reasonably established that NYNEX installed fiber optic facilities in a quantity and configuration that was the least cost method of providing telephone service. While we did not rely on the existence of overcapacity or the fact that NYNEX may be able to use that overcapacity, for the purpose of making any adjustments to rate base, those facts were considered by us when we determined the size of the productivity factor in Docket No. 94-123.

B. Digital Switch Costs

Staff witness Dirmeier recommended that NYNEX's revenue requirement be reduced by \$7,901,000 as a disallowance of excess digital switching costs from rate base. That recommendation was based on the testimony of Staff witness David Gabel that NYNEX's per-line switching costs were excessive. Dr. Gabel claimed he first became aware of NYNEX-Maine's high costs while doing his general cost study. In particular, Dr. Gabel claimed that the digital switches installed by NYNEX in Maine over a period of time were much more costly on a per-line basis than the switches that Bell Atlantic had installed in Pennsylvania. On a per-line basis, the cost of switches installed in Pennsylvania from 1984 to 1992 averaged \$162 per line. The installed cost of \$275 per line of Maine switches is approximately 69% higher than that for the Bell of Pennsylvania switches. Dr. Gabel also pointed out that Ameritech, the Bell Operating Company in the Great Lakes area, was able to negotiate discounts with Northern Telecom that reduced its per-line switching costs by 40%, and that NYNEX-Maine had, to his knowledge, failed to secure similar discounts. He also indicated that cost studies filed by NYNEX in New Hampshire and Massachusetts showed much lower switching costs.

Mr. Helgeson responded that the claim that Ameritech had reduced its switching costs was highly misleading because significant discounts are frequently obtained from switch manufacturers. He stated that list prices from switch manufacturers are like rates for hotel rooms or car rentals, for which no one pays full price. However, he failed to testify about whether NYNEX had obtained those discounts.

Mr. Helgeson also claimed that Dr. Gabel's comparison of costs from Massachusetts and New Hampshire was misleading. He explained that cost studies submitted by NYNEX at different times to different jurisdictions, in compliance with state-specific mandates, can have greatly differing results. He cited our recent NYNEX cost study case, Docket No. 92-130, to demonstrate that a study procedure mandated by the Massachusetts DPU, that based marginal costs on capacity, had been expressly rejected by this Commission.

Mr. Helgeson attempted to rebut Dr. Gabel's primary argument that Maine's switching investment costs were higher than those in Pennsylvania by claiming that the number of customers served by each switch caused the cost difference observed by Dr. Gabel. He also claimed that the different size switches used in Pennsylvania made a comparison between Maine and Pennsylvania switching costs meaningless. According to Mr. Helgeson, there is a direct correlation between the investment per line and the average size of the switch being replaced. He relied on the Company's response to Staff data request 10-4 to support this claim.

We do not find that the data response supports Mr. Helgeson's claim. The response contained only columns (a) through (e) of the table below. Based on data in those columns, we have calculated column (f).

MAINE SWITCHING COSTS

| Year | # of new switches | Investment (\$M) | #Lines (000) | Investment per line \$ | Average Lines per Switch (000) |
|------|-------------------|------------------|--------------|------------------------|--------------------------------|
| (a) | (b) | (c) | (d) | (e) | (f) (=d÷b) |
| 1984 | 1 | 2.3 | 14.1 | 166 | 14.1 |
| 1985 | 1 | 2.3 | 6.4 | 361 | 6.4 |
| 1986 | 9 | 17.5 | 71.4 | 245 | 7.9 |
| 1987 | 5 | 7.2 | 32.9 | 219 | 6.68 |
| 1988 | 12 | 17.7 | 72.6 | 244 | 6.15 |
| 1989 | 21 | 17.1 | 47.9 | 356 | 2.38 |
| 1990 | 27 | 37.2 | 137.7 | 270 | 5.1 |
| 1991 | 27 | 25.1 | 73.4 | 340 | 2.7 |
| 1992 | 35 | 26.1 | 94.7 | 275 | 2.7 |

Derived from Staff-10-4.

The table in fact tends to establish, at least in Maine, that switch size has only a minimal correlation to investment per line. Many years in which new switches on average were smaller show lower costs than years in which average switch size was larger. For example, in 1991 and 1992 the investment per line declined from \$340 to \$275 even though the average lines per switch remained relatively constant. From 1986 to 1987 the average switch investment declined even though the average switch size also declined.

The evidence shows that NYNEX invested certain amounts in switches between 1984 and 1992. Staff then raised the issue that the cost of those switches was higher than that paid by other regional Bell operating companies. In particular, Pennsylvania Bell may have paid \$7.9 million less for comparable switching capacity. In response, NYNEX did little more than claim that Pennsylvania was not a valid comparison. The limited but essentially unrebutted comparisons provided by the Staff might justify disallowing some switching costs as imprudent and unreasonable. However, we are unwilling to make a large rate base adjustment without a stronger evidentiary basis for the amount of switching costs that are unreasonable. Therefore, we will not adjust NYNEX's rate base at this time. This does not, however, foreclose any party with more particularized evidence about the cost of Maine switches, from petitioning the Commission to investigate this matter further. That particular evidence would have to include the comparability of any other switch cost data, both with respect to switch size and installation dates, and an analysis of what was included in the switch purchase price.

C. Working Capital

The inclusion of an allowance for working capital has been a standard practice at this Commission for many years. This addition to the utility's rate base is necessary to allow the utility to recover the costs associated with funds supplied by investors above the amount that supports the utility's plant and equipment. No party in this case disputed the need for a working capital allowance. NYNEX presented a lead-lag analysis in support of its proposed allowance that was also generally accepted by all parties. The only area of disagreement relates to inventories.

In addition to the cash portion of the working capital allowance, NYNEX's investment in inventories has regularly been included in rate base through the working capital analysis. NYNEX must keep an inventory of repair materials and supplies available to meet day-to-day requirements of providing service. OPA witness Mr. Allen disputed the amount of such inventories in rate base. He proposed to reduce working capital by \$670,000 to reflect the average balance of materials and supplies in the test year. According to Mr. Allen, the approach most commonly used is to include average material and supplies inventories in rate base. In this manner, only the average outstanding investment is allowed to earn a return. The OPA is concerned that the

method employed by NYNEX would allow for a double recovery of inventory purchases, first as a material and supplies purchase and again as an addition to the Telephone Plant Under Construction (TPUC) account.

In calculating the working capital component of rate base, NYNEX included only the material and supplies that it actually paid for in the test year. In this manner, NYNEX claims it is being "conservative" by excluding those amounts that are in the materials and supplies account that it did not pay for in the test year. NYNEX believes that the concerns expressed by the Mr. Allen are not likely to occur due to the procedure it used to develop the working capital component. The ratio of paid-for versus received materials and supplies was developed for the period and then applied to the average balance in the materials and supplies account. Therefore, the results would not include amounts that had been either transferred to TPUC or expensed.

It has been this Commission's preferred methodology to include a 13-month average balance of materials and supplies in rate base. This methodology was proposed by the utilities, uncontested by all of the parties, and accepted by the Commission in the last three major rate cases before the Commission. Camden and Rockland, Maine and Wanaqua Water Companies, Proposed Increase in Rates, Docket No. 93-145, Order (Part II) at 54 (July 12, 1994), Central Maine Power Company, Proposed Increase in Rates, Docket No. 92-345, Order at 48 (Dec. 14, 1993), and Bangor Hydro-Electric Company, Proposed Increase in Rates, Docket No. 93-062, Order at 6 (Mar. 16, 1994). While NYNEX has presented testimony to address the OPA's concern regarding the double recovery of its investment in materials and supplies, it has provided no testimony on the more important issue of why its methodology is more appropriate than that currently employed by the Commission. We find no reason to abandon the use of the average balance as an appropriate methodology to calculate working capital requirements associated with material and supplies inventories. We therefore accept the OPA's proposed reduction of \$670,000 to working capital.

NYNEX's witness, Mr. Micciche, included \$16.019 million in the unadjusted test year as a working capital allowance. In his rebuttal testimony, he revised this amount to eliminate \$22,000 associated with contractor retention. As discussed above, working capital is being reduced by an additional \$670,000 for a total reduction to NYNEX's unadjusted test year working capital allowance of \$692,000. We accept a working capital allowance of \$15.327 million.

D. First Roach Pond

During the hearings on February 15, 1995, NYNEX was asked to provide in writing the amount included in test year rate base for NYNEX's recent investment related to the First Roach Pond line extension, including the amount depreciation. The next day, the Hearing Examiner informed the parties that the Commission wished to consider in this docket the prudence of NYNEX's actions surrounding the so-called First Roach Pond case. *Fred Rogers et. al. v. New England Telephone Company*, Docket No. 91-288, Decision and Order No. 1 (Sept. 25, 1992) (hereinafter Order No. 1); Order No. 2 (Dec. 7, 1992) (hereinafter Order No. 2); Order No. 3 (May 4, 1993). The Examiner made clear that the only information the Commission would rely on was that contained in the orders issued in that proceeding. NYNEX responded to the bench oral data request on March 3, 1995. This response became Hearing Examiners' Exhibit 10 and is part of the record pursuant to the Commission's Rules of Practice and Procedure, Chapter 110, § 925.

Before deciding this issue, it is necessary to review briefly the background leading up to NYNEX's investment in the line extension. On October 21, 1991, Mr. Fred Rogers and 29 other individuals filed a complaint with the Commission pursuant to 35-A M.R.S.A. § 1302. The complainants requested that NYNEX's Greenville exchange be extended to include an area along the south shore of First Roach Pond in Frenchville Township. The complainants alleged that NYNEX had formerly served customers in this area and so was required to serve the complainants who were current residents in the area. NYNEX responded that it was willing to extend the Greenville exchange but that the complainants would have to pay "all costs of providing such service consistent with NET's [NYNEX's] schedules." Order No. 1 at 1.

Following hearings, the Commission found that the area was not within NYNEX's boundary map of the Greenville exchange. However, for a number of years, NYNEX had served a business that allowed three residential customers to use its line to obtain party-line service from NYNEX. In all material respects, these customers were treated like NYNEX's other customers located within the Greenville exchange boundary: their service was installed by NYNEX, they used NYNEX equipment, they were billed by NYNEX and they appeared in NYNEX's telephone directory. After the Commission approved elimination and grandfathering of certain party-line service, the business chose to discontinue maintaining the party-line service with the three residential customers. NYNEX subsequently disconnected the three customers' service in April 1988. *Id.* at 2-4.

Based on these facts, the Commission concluded that in the absence of Commission approval to discontinue service, NYNEX had no authority to discontinue service to the three residential customers and did so in violation of 35-A M.R.S.A. § 1104. Order No. 1 at 10. Given that a factually similar situation had arisen previously

on Monhegan Island, NYNEX knew or should have known that unavailability of a facility owned by another entity did not relieve NYNEX of the obligation to serve that it incurred because of its long-term service over that facility. *Id.* at 7. The Commission found that because NYNEX had provided service to at least some customers along the south shore of First Roach Pond, it had an obligation to provide service to other customers in the same area on a non-discriminatory basis. Because NYNEX willingly provided service to customers in that area, the area along the south shore was part of NYNEX's service territory. *Id.* at 11-15.

After further briefing by the parties, the Commission also found that NYNEX's line extension tariff (Part A, Section 2.1.2.C.) required it to extend the line to the south shore of Roach Pond at no additional charge to customers as long as there was one customer per half-mile. The Commission further found that the standard of disproportionate revenues to cost in the Special Conditions Section (2.1.6.C.) was inapplicable when the disproportionality is caused solely by "low" customer density that nevertheless meets the specific density standard (one customer per half mile) of Section 2.1.2 of the tariff. The Commission's conclusion about the relationship between the various sections of the terms and conditions was supported by the well-known rule of statutory construction, that where two provisions arguably cover the same subject matter, the more specific provision will prevail over the more general. Order No. 2 at 10-14. The disproportionality standard also was inapplicable to the required reinforcements that were governed by Section 2.1.2.B. *Id.* As noted by the Commission, a problem throughout this entire matter was NYNEX's apparently overly-generous line extension policy. Order No. 1 at 16; Order No. 2 at 10-14.

NYNEX in its Reply Brief incorrectly frames the issue. It claims that only if its investment resulted from the unlawful disconnection of the three customers should it be found imprudent. The disconnections, although unlawful, are not the primary issue here. The imprudent investment was brought about by NYNEX's having initially served the three customers who were outside its service territory at the time NYNEX commenced service to them.

NYNEX also seems to argue that it was the Commission's interpretation of its line extension tariff that caused the investment and that NYNEX was not imprudent because it could not have foreseen that the Commission "would rule against the meaning intended by the Company in drafting its special construction provisions." According to NYNEX, "it could not have taken any steps prior to the Commission's decision to redraft the applicable provisions." *Nynex Reply Brief* at 31. This argument is entirely without merit. Anyone reading section 2 of NYNEX's tariffs, whether utility employee, regulator or customer, would be hard pressed to understand how it would apply to the First Roach Pond situation when another tariff section specifically addressed areas that were sparsely-settled on average as only one customer per half-mile. That section provides that customers must pay only for construction costs that

are in excess of those for one half-mile of free construction for each customer. NYNEX now argues that it could not have foreseen that in 1992 the Commission would reject its completely unmeritorious argument that the "disproportionality" provision could negate the specific free half-mile provision. NYNEX's argument today is equally without merit.

If NYNEX believed that the Commission ruled "against the meaning intended by the Company in drafting its special construction provisions," then it is inexplicable why it has not proposed to amend its tariff since that order. Both the "disproportionality" and the free half-mile per customer provisions of the construction tariff remain unchanged. Although NYNEX may be waiting for a generic rulemaking, it has an obligation to ensure that the tariffs it has on file will not result in either unfair or arbitrary application to some customers or unduly burdensome costs on ratepayers. If NYNEX disagreed with the ruling, it could have asked the Commission to reconsider its decision, or could have appealed the decision to the Law Court. It did neither. The Commission's decision in Order No. 2 became final upon its issuance and delivery to NYNEX on December 7, 1992. Its merits, therefore, cannot be argued now.

As a result of NYNEX's actions of providing service to customers beyond its service territory, NYNEX became obligated to serve others in the area. Due to its overly generous line extension tariff, it was unable to charge those seasonal customers for the line extension needed to serve them. NYNEX's imprudent behavior in holding out service beyond its service territory, even after the Monhegan decision was issued, and its inadequate line extension policy, resulted in NYNEX's other ratepayers having to absorb these costs. We therefore disallow from rate base all capital costs associated with this project in the test year. We remove \$305,810, the average test year rate base amount, along with associated depreciation of \$17,427.

E. Rate Base Summary

Having examined each of the individual adjustments to the test year as proposed by the parties, we find that the adjusted test year rate base to be \$461.462 million.

IV. COST OF SERVICE ADJUSTMENTS

No party has disputed NYNEX's use of the 12 months ending May 31, 1994 as its test year. NYNEX proposed a number of "normalizing" and "known and measurable" changes to its test year to arrive at a recommended adjusted test year. The parties to this case have recommended a number of adjustments to NYNEX's adjusted test year. We have examined each adjustment proposed by the parties. All accepted or modified adjustments have been reflected as adjustments to NYNEX's unadjusted test year.

Certain adjustments proposed by the parties were accepted completely by all the parties and have been reflected as adjustments to NYNEX's unadjusted test year and will not be discussed further. Those are:

- Omitted new tariff revenues
- Affiliated interest
- Wage adjustment for employee count correction
(We note that a separate wage adjustment has been proposed to reflect test year and attrition year wage increases.)
- Charitable contributions
- Conversion to NYNEX brand-name
- Correction of surplus deferred amortization
- January 1994 pole rental increase
- Elimination of 1991 restructuring costs
- Elimination of plant not used and useful
- OPEB correction
- TDD relay
- June 1994 exchange reclass
- Interest synchronization
- Interest charged during construction

A. Process Re-engineering (PRE)

Process Re-engineering (PRE) is the name given by NYNEX to the company-wide initiative to redesign or re-engineer the way it provides service to its customers. It differs from traditional cost-cutting in that the initiative seeks to develop entirely new work methods and procedures and is not simply a reduction in the number of employees. Nonetheless, over the entire course of Process Re-engineering, NYNEX has forecasted a reduction of 115 assigned management employees and 471 assigned nonmanagement employees in Maine.

In February 1993, NYNEX announced the beginning of its Process Re-engineering effort. Expenses for PRE will continue through 1996. Actually incurred and projected expenses by NYNEX-Maine for this period are expected to be \$112.1 million, or \$85.6 million intrastate.¹⁰ For the rate effective year of June 1, 1995 through May 31, 1996, NYNEX has forecasted projected PRE expenses of \$23.6 million and operating expense savings related to PRE initiatives of \$25 million.

No party disputed the estimates prepared by NYNEX for the PRE expenses, PRE savings, or the timing of PRE expenditures. All parties have advocated deferred tax treatment of the costs associated with the PRE program.¹¹ No party claimed the PRE program is imprudent.

The only remaining issue relating to NYNEX's PRE program is whether and in what manner the costs should be reflected in the Company's cost of service and recovered from ratepayers. NYNEX asked that the \$23.571 million it will expend during the rate effective year be treated as a normal cost of providing service and therefore reflected in rates. NYNEX has not asked for, nor would its proposed treatment allow for specific recognition in rates of, the \$62 million in expenditures it

¹⁰The Public Advocate estimated the intrastate costs at \$85.252 million. Catlin Pref. Dir. Test. Exh. TSC-1, Sch.1.

¹¹In his direct testimony, Mr. Micciche advocated flow-through tax treatment of the PRE costs in accordance with Commission rules that state that "[t]he flow-through method of treatment of tax timing differences shall be used unless specifically prohibited by provisions of the Internal Revenue Code." MPUC Rules, ch. 210, § 8(F)(1). In his rebuttal testimony, Mr. Micciche agreed that flow-through treatment distorts the revenue requirement results and therefore reflected current tax treatment in his revised revenue requirement. This reduced revenue requirements by \$13.227 million. We agree that the nature and magnitude of this expense warrants a departure from Commission rules relating to the treatment of tax timing differences. We therefore grant a waiver of Chapter 210, § 8(F)(1) pursuant to section 6 of Chapter 210.

incurred for PRE in years prior to the rate effective year. NYNEX cited Generally Accepted Accounting Principles (GAAP), and Federal Communications Commission (FCC) Responsible Accounting Officer (RAO) Letter 24 as support for its proposed treatment of the PRE costs. No party appears to have taken issue with NYNEX's contention that the cited authority requires it to record the PRE costs in the manner it has proposed for statements filed with the Securities and Exchange Commission (SEC) or the FCC. However, recognition of the expense for ratemaking purposes is not necessarily governed by the reporting requirements imposed on NYNEX by the SEC, FCC, or GAAP. NYNEX never suggested that the Commission is limited in its authority to address the recognition of the PRE costs, only that its own recommendation is supported by GAAP and the FCC.

The Staff recommended that all costs associated with the restructuring be eliminated from the test year and attrition year and that NYNEX be afforded no specific recognition of its PRE costs in this proceeding. The Staff argued that in the future NYNEX will continue to receive savings from the cost reduction program while incurring no additional costs. After December of 1996, pre-tax savings of \$26.65 million will continue to flow to NYNEX while all costs will disappear. Matching \$23.571 million of one-time attrition year expense with recurring cost savings of over \$26 million, enables NYNEX to overearn in post attrition years by at least \$14.9 million.

Staff also argued that the regulatory balance that has prevailed in Maine is being overturned in this proceeding. According to the Staff, under an AFOR, NYNEX will retain greater rights to initiate an earnings review than will ratepayers; in order to provide some protection to ratepayers, the Commission should therefore ensure that the future benefits of PRE will be retained by ratepayers.¹²

Finally, Staff argued that NYNEX already recovered \$58 million of its PRE costs through overearnings in the test year ending May 31, 1994 and in the post-test year ending May 31, 1995. The basis of this calculation appears to lie in the summation of projected test year excess revenues of \$25 million and a post test year excess of \$33 million. That calculation is based on Staff's view of the total costs in those years and includes PRE expenditures which actually occurred in those years. Since the Commission has not adopted all of the adjustments advocated by the Staff in its testimony, Staff's calculation of excess earnings in those years is not consistent with the Commission's findings in this proceeding. It is possible, however, as the Staff points out, that NYNEX may have had rates sufficient to absorb some portion of the

¹²Staff's premise is incorrect. As explained in Part III.C.9. of the Order in Docket No. 94-123, pursuant to 35-A M.R.S.A. § 9102, we can and do suspend NYNEX's right to initiate a general rate increase under 35-A M.R.S.A. § 307. Sections 9102 and 9103 grant the Commission no equivalent power to alter the rights of ratepayers to petition for a rate change under section 1302.

costs of the PRE program incurred prior to the rate effective period. On the other hand, the benefits, estimated in excess of \$25 million during the rate effective year and nearly \$32.0 million in subsequent years, are not certain. As discussed in more detail below, we believe the best estimate of the net annualized savings from the PRE initiative will recognize both of these uncertainties.

The OPA recommended that NYNEX be allowed to recover all of the costs of PRE by amortizing the costs of the program over a period approximately equal to the remaining service period of the departing employees. The OPA calculated the total costs of the program to be \$85.282 million for the Maine intrastate operations. The savings to be realized through April 1, 1995 were estimated by the Company at \$9.251 million, leaving \$76.031 million of unrecovered costs. The OPA proposed to defer these costs for recovery over an 8-year amortization period, or \$9.504 million of cost recovery per year.

The OPA also expressed the concern that adopting NYNEX's position would set rates to recover an expense which will disappear 7 months after the rate effective year. To address this asymmetric flow of costs and savings, the OPA would defer all pre-attrition year costs, net of the savings, and amortize them over the period of projected future savings. We agree with the OPA's position that the costs of the PRE program need to be flowed over the time frame of the projected savings. However, as discussed below, we do not believe that the costs should be explicitly separated from the savings resulting from the PRE program. A better approach is to calculate the net annualized savings of the PRE program and reflect this amount as the normalized benefit of the program over the projected duration of the program.

Neither the Staff nor the OPA disputed that NYNEX will expend \$23.571 million in the rate effective year and NYNEX acknowledged that PRE expenditures will cease subsequent to December 31, 1996. Because no party disputed the existence of the expenditures during the rate effective year, and no evidence has been offered that the expenditures are imprudent, there is no justification to disallow the recovery of those costs under traditional ratemaking principles. Under such principles, the historic test year is adjusted where there is sufficient certainty that a change will occur in the first year that new rates are in effect. Central Maine Power Co., Proposed Increase in Rates, Docket No. 92-345, Order at 45 (Dec. 14, 1993). On the other hand, adoption of an AFOR for at least a five-year period is a clear move away from rate base, rate-of-return regulation and will limit future reviews of rates. Generally, under traditional rate-of-return regulation, we attempt to set rates based on a view of a very limited future, the "rate effective year" that begins when rates go into effect and ends one year later. The traditional limited horizon has its basis in the reality that the further one moves away from the rate effective year, the less certainty there is that another event or combination of events will occur to mitigate any anticipated change in cost or revenues.

In this case, there is no doubt that the \$23.571 million cost for PRE that NYNEX will incur during the rate effective year will be eliminated shortly thereafter. The size of this particular expense item and the magnitude of its earnings effect make it difficult to conceive of another expenditure that might take its place after December 31, 1996. Eliminating this expense item will almost certainly change the relationship between expense and revenue in the years beyond the rate effective year. Therefore, it is difficult to limit our consideration to only the impacts of the PRE program in the rate effective year. Two factors make this approach particularly difficult. First, the PRE program must be viewed as a long term project in which initial costs are weighed against future savings. Second, because of the AFOR, we are not likely to address formally any future mismatch in revenues and expenditures resulting from decisions in this proceeding.

The timing of this rate proceeding is such that the rate effective year occurs when PRE costs are declining but savings have not been fully realized. Any argument to capture the future savings without specific recognition of all the costs incurred to achieve those savings is only possible due to the particular point in the project's life cycle at which this proceeding happens to fall. If this proceeding coincided with the beginning of the project's life cycle, it would be hard to argue that consideration not be given to all potential future costs. Likewise, if the proceeding occurred towards the end of the project's life cycle, no adjustment would be required at all since all savings would be fully reflected in test year operations. Compounding this timing dilemma is our knowledge that whatever future impacts our current treatment of PRE has on the Company's ability to earn its required rate of return will not likely be dealt with in a traditional manner, i.e., a future rate case proceeding.

Concluding that it is inappropriate to limit our consideration to only the rate effective year costs and savings, persuades us to treat the PRE program as a multi-year project in which all of the costs and savings will be reflected in rates. NYNEX quantified the total costs of the program through December 31, 1996 at \$85.6 million. Modest savings would begin to be realized by late 1994 or early 1995 and grow to an annual level of approximately \$31.9 million by late 1996. While there is some uncertainty as to the level of ongoing savings and the timeframe over which they will be achieved thereafter, it is not unreasonable to assume that the PRE program will continue to provide some level of benefits into the future. We have chosen to quantify the savings over an 8-year period beginning with the announcement of the PRE initiative, February of 1993, and running through the initial term of the AFOR, approximately December 31, 2000. We have quantified the savings over this 8-year period at \$180.5 million. We calculated this amount as the sum of the estimated savings of \$34.3 million through May 31, 1996 and the annualized amount of \$31.9 million between June 1, 1996 through December 31, 2000. The 8-year time period is appropriate since an investment of this nature, in which costs are incurred upfront to

achieve future benefits, requires a longer term perspective and because the AFOR plan has an initial term ending in December of 2000.

The approach we are adopting is similar to that proposed by the OPA in that it recognizes the costs required to achieve the future savings. However, we believe that the PRE program can not be explicitly separated into a cost component and a savings component. The program must be considered in its entirety in order to better match the required expenditures with the projected savings. In this way, we can calculate the normalized net savings level associated with this project that will be included in each year of the expected life of the program. Netting the \$85.6 million in costs with the \$180.5 million of projected savings, and dividing by the eight years of the program, yields annual net savings of \$11.9 million. We will reflect a normalized net savings amount of \$11.9 million in the test year and the attrition year.

B. Depreciation

NYNEX proposed an adjustment to depreciation that would decrease its earnings by \$3.8 million and increase its revenue requirement by \$6 million under its proposed rate of return. That change is based on implementation of NYNEX's Maine revised intrastate depreciation rates contained in its 1993 Depreciation Rate Study. NYNEX filed that study with the Commission on December 17, 1992. In anticipation of NYNEX's making such a filing, the Commission on November 23, 1992 opened an investigation into the proposed depreciation rates. Public Utilities Commission, Investigation Into New England Telephone Company's Represcription of Depreciation Rates, Docket No. 92-316. This case was treated as a non-adjudicatory matter. No party ever requested a hearing or further Commission action and, accordingly, the Commission has never taken any action. The docket remains open. On January 24, 1994, the Federal Communications Commission (FCC) adopted the rates contained in the study for interstate purposes.

The Staff argued that the current depreciation rates in place (1990 FCC prescribed rates) should be used to calculate the revenue requirement. Staff claimed that the increased depreciation is primarily based on obsolescence caused by NYNEX's modernization program to offer the next generation of high-tech premium services. Therefore, ratepayers whose principal desire is for "plain old telephone service" (POTS) should not be burdened with increased costs caused by the need to accelerate the depreciation of that modernized network. The Staff also noted that if NYNEX becomes subject to a price cap AFOR, NYNEX should be granted the flexibility to adjust its depreciation rates as it sees fit, provided it keeps records sufficient to track its calculations.

The OPA also urged the Commission to use the depreciation rates that are currently in effect in Maine. The OPA argued that NYNEX's proposal to use the

rates from the 1993 study has no evidentiary support as the study has not been put into evidence in this case.

NYNEX has proposed to use the rates contained in the 1993 study. NYNEX itself never offered the study into evidence, nor any testimony to support the contents of the study. The study is only in the record because during the hearings, the Staff asked that administrative notice be taken of the file in Docket No. 92-316. NYNEX did not object and we therefore took official notice of the file. Procedural Order Concerning Official Notice, Docket Nos. 94-123, 94-254 (Mar. 24, 1995). Taking notice of the file and the study contained in it, however, does not mean we accept the study results at face value. NYNEX stated in its Brief that "No party presented evidence challenging the Company's substantive conclusions on depreciation." NYNEX, however, misplaces the burden of proof. It presented only conclusions. It did not present any evidence that would allow the Commission to determine that its conclusions were reasonable. See, e.g., *Casco Bay Lines v. Public Utilities Commission*, 390 A.2d 483 (Me. 1988) (upholding the Commission finding that pension expenses were not reasonable because utility failed to present any significant evidence to support the expenses, thus failing to meet its burden of proof).

Accordingly, we will leave NYNEX's current depreciation rates in place for the purpose of establishing the revenue requirement in this case and setting a fair starting point for the AFOR. As described in our Order in Docket No. 94-123, once the AFOR takes effect, NYNEX will have an opportunity to depreciate its least economic assets more rapidly to bring the book value of its assets down to their actual economic value. We agree with Staff that NYNEX should maintain adequate records to support any changes in the event the depreciation rates need to be examined in the future. We also close Docket No. 92-316 as there is no need to "investigate" NYNEX's 1993 depreciation rate study once the AFOR is in place.

C. Attrition

The purpose of an attrition analysis is to determine whether a utility will have a reasonable opportunity to earn the allowed return as calculated under the test year (with known and measurable changes) concept. In effect, attrition goes beyond the test year into the rate-effective period to determine whether the adjusted test year balance among rate base, expenses, and revenues will change in such a way that earnings may erode (attrition) or increase (accretion or negative attrition).

NYNEX and the Staff have, throughout the discussion of the issues in this section, calculated compound annual growth rates (CAGR) using historic data. The compound growth rate essentially ignores the data between the first and last year. The compound growth rate formula is:

$$\text{CAGR} = [(\text{Total Growth})^{1/n} - 1] \times 100\%$$

Where: Total Growth = Value in last year ÷ Value in first year

N = number of years from first to last year

The OPA's witness, Mr. Catlin, used a more complex and detailed technique, based on the trend-line method (trended or continuous growth). While the calculation of the trend-line is complex, it explicitly takes into account results in the intervening years. The objective of the trend-line method is to determine the slope of the regression line that best fits the logarithms of the inputs being studied.

All parties have agreed that the trending analysis is likely to produce more accurate predictions. We also agree that trended growth rates are preferable to compound growth rates and will use them in our analysis throughout our discussion of attrition.

NYNEX has calculated accretion in the rate year of about \$36 million. The Advocacy Staff determined accretion to be approximately \$17 million while the OPA calculated accretion of approximately \$27 million. Two issues which have post test year impacts are discussed in other parts of this Order. Process Re-engineering (PRE) is discussed in Part IV.A, and Wage and Bonuses are discussed in Part IV.E. While these two issues have post test year impacts, the parties have briefed them separately from their discussion of the more traditional attrition issues contained in this section due to their complexity and the impact they have on the overall revenue requirement. The difference in the accretion calculated by each party reflects that party's treatment of the PRE adjustment, the wage and bonus adjustments and the remaining attrition issues discussed below in this section.

1. Local Service Revenues

NYNEX projected annual increases in local service revenues between the test year and the rate year at an annual rate of 2.85%, based directly on the projected annual growth in access lines. Annual access line growth is forecast to average 2.8% in 1995 and 2.9% in 1996 on a composite basis. NYNEX identified growth in access lines as a primary driver of local revenue growth. NYNEX has computed the actual compound annual growth rate (CAGR) in local service revenues for the period 1989 to 1993 at 3.02%.

The Staff recommended a local service revenue growth rate of 4.0%. The Staff argued that 1) the use of an access line measure for local service revenues accounts for only a part of the change in local service revenue, 2) actual growth in access lines during 1994 will be approximately 3.6%, which suggests an

understatement by NYNEX of the true growth in access lines during this period, and 3) even if NYNEX's forecasted growth of 2.85% in the attrition year is not understated, the historic differential would support a growth rate for local service revenues of approximately 3.85%. Using the historic growth in both local service revenue and access lines from 1988 to 1993, the Staff calculated a 0.89% differential between the CAGR of local service revenue and the CAGR in access lines. The Staff multiplied this differential to NYNEX's projected annual growth in access lines of 2.85% to arrive at an annual 3.77% estimate of local service revenue growth $(((1.0285 \times 1.0089) - 1) \times 100)$. However, the Staff recommended a 4% growth rate, relying on the calculated 4.83% annual growth rate in access lines during the 9 months ended September of 1994.

The OPA recommended an annual growth rate in local service revenue of 4.23% based on the differential in trended growth rates between local service revenue and access lines over the period 1988 to 1993. The analysis performed by the OPA's witness, Mr. Catlin, indicated that local service revenues had grown at a rate of 1.38% per year higher than the growth in access lines over this period. Adding that differential to NYNEX's projected annual growth in access lines of 2.85% yields an annual growth rate for local revenues of 4.23%.

NYNEX criticized the methodology employed by the Staff and OPA because it assumes that a trend can be determined for the differential between the growth in local service revenue and access lines even though such a relationship has historically been neither uniform nor consistent. During the 5 years examined, the growth in local service revenue was substantially greater than growth in access lines in 3 years, somewhat greater in one year and lower in another. The Staff and the OPA did not provide any analysis of the reasons for the variability, or whether the differential can be expected to continue. NYNEX also argued that a second and separate analysis should have been performed to determine the extent to which existing customers will increase their subscription rates for new and existing products, and to what extent such increases will require additional expenditures and investments.

NYNEX believes that the growth in access lines is the primary driver of the growth in local service revenue. That claim indicates that an analysis of the relationship between the two is appropriate when attempting to forecast future growth in local service revenues. NYNEX did not provide the analysis of this relationship that it claims should have been provided, nor has it put forward specific reasons why this relationship will not continue in the future. It has only argued that the Staff's and OPA's analysis of this relationship is less than comprehensive, and that a more thorough analysis might have yielded a different result.

Even though no evidence was presented to explain fully the reasons for this relationship or to suggest that it would not continue in the future, there is no doubt from the analysis performed by the Staff and the OPA that growth in local

service revenue has outpaced the growth in access lines since 1988. It is also clear from the analysis that the variability in the year to year differential between the growth in local service revenues and the growth in access lines appears to be about twice as great as either of the two components of the differential.

| Year to Year Growth | | | | | |
|---------------------|----------------------|-----------------|---------|-----------------|------------|
| | Revenue (1) (000) | Access Lines | Revenue | Access Lines | Difference |
| 1988 | \$120,165 | 523,971 | | | |
| 1989 | \$124,599 | 545,773 | 3.69% | 4.16% | -0.47% |
| 1990 | \$130,654 | 559,237 | 4.89% | 2.47% | 2.42% |
| 1991 | \$132,980 | 565,737 | 1.78% | 1.16% | 0.62% |
| 1992 | \$138,599 | 574,881 | 4.23% | 1.62% | 2.61% |
| 1993 | \$143,253 | 588,274 | 3.36% | 2.33% | 1.03% |
| Trended | Growth Rate | 1988-1993 | 3.53% | 2.15% | 1.38% |

Catlin Pref. Dir. Test., Exhibit TSC-2, Schedule 2.

Nevertheless, except in 1989, the differential has always been positive, providing a strong indication that local service revenue can be expected to grow at a greater rate than access lines in the future. Notwithstanding this evidence, NYNEX simply assumes that the growth in local service revenue will be exactly equal to the growth in access lines, which it projects to be 2.85%. The 2.85% growth in revenues appears low from an historic perspective when compared to OPA's 3.53% trended growth rate, particularly when NYNEX has projected a growth in access lines that is greater than the historical trend of 2.15%. Plainly, NYNEX's proposed growth in local service revenue is too low because NYNEX has totally ignored the existence of the differential between access lines and revenue growth.

We decline to add the calculated differential between historic growth in local service revenue and historic growth in access lines (1.38%) to the growth in access lines (2.85%) projected by NYNEX. The relatively high variance of the differential indicates that it is not likely to be a good predictor of the future differential. This is particularly true when added to a 1-year access line projection, and when the resulting prediction of local service revenue growth will serve as a significant component of the starting point for rates that will remain in effect (subject to the AFOR price index) for 5 years.

Accordingly, we will use the 3.53% historic growth trend in local service revenues calculated by OPA witness Catlin. It is a direct calculation of the very quantity we are seeking to find, local service revenue. The actual historical differential between local service revenue and access line growth is automatically included in the calculation. In addition, by using the historic growth trend, we are applying the same method that we are using for other components of the attrition analysis in this case. We, therefore, find that the OPA's trended growth rate in local service revenue of 3.53% is a fair estimate of expected annual growth in local service revenues for the period between the test year and the rate year.

2. Network Access/Toll Revenue

NYNEX recommended a 40% annual increase in access revenue between the test year and the rate year with no increase in toll revenue during this period. The OPA accepted NYNEX's projection of network access and toll revenue. The Staff's witness recommended a 55% increase in access revenue and no increase in toll. Both NYNEX and the Staff agreed that network access and toll revenues are related and that the growth rate applied to network access should be analyzed for its combined impact on access and toll revenue. Both also agreed that access revenue has grown at an annual rate of 23.07% and that toll revenue has grown at an annual rate of 3.21% from 1988-1993.

NYNEX argued that the recent high growth rates in access revenue cannot be maintained in the future because of increased competition associated with new carriers and resellers entering the market. The argument is curious, inasmuch as new carriers provide access revenues. NYNEX has projected access revenue growth of 33% in 1994. Based on the 1994 projection, it argues that its proposed 40% annual growth rate for the rate effective year is reasonable, with any growth in excess of this rate coming at the expense of toll revenue.

Staff agreed that the growth rate in access revenue has been very high over the last 5 years, and that the historic annual growth rate can be somewhat misleading because access is a relatively new service. Notwithstanding that observation, the 55% annual growth recommendation would produce annual dollar increases in toll and access revenue that are slightly below those experienced for non-normalized toll and access revenues for the 4 years 1989 to 1993.

It seems appropriate that growth in access and toll revenues should be analyzed on a combined basis to recognize the inherent relationship that exists between them, as they represent wholesale and retail sales of interexchange services. Both NYNEX and the Staff calculated identical normalized annual growth rates for the period 1988-1993 (23.07% access, 3.21% toll, and 3.56% combined), but neither party recommended use of these specific rates.

As recognized by Staff, the 1988 data was abnormally high and substantially impacted the overall results. Chapter 280, which governs access charges and required NYNEX to file access charges, was not adopted until November of 1988. There was virtually no access revenue in 1988 and it is a very poor base year to use for the beginning of a trend. Elimination of the 1988 data yields a 1.69% trended growth rate in combined access and toll revenue for the period 1989-1993. If applied only to access revenue, the 1.69% growth rate results in a 47% annual growth rate for the 2 years between the test year and the rate year. Including the 1988 data yields a combined trended growth rate of 2.92% with a corresponding 74% annual growth rate if applied only to access revenue. While we are normally cautious about including or excluding specific historic data simply to eliminate apparent inconsistencies or large variances, a single aberrant year that causes a difference of nearly 30% in the annual rate over a 5-year period should not be included. The objective of a trending analysis is to mitigate the undue influence of any one data point while giving weight to all. It is clear that the usually low 1988 data has unduly influenced the trending results. We find that a 47% annual increase in access revenue and no increase in toll revenue is appropriate.

3. Late Payment Charges

In its direct and rebuttal testimony, NYNEX proposed no increase in late payment revenues in the attrition year. The Staff accepted NYNEX's original position of no increase in late payment revenue and did not brief the issue further. The OPA has calculated late payment revenues for the attrition year by multiplying the attrition year revenue base by the test year ratio of late payment charge revenues to the test year revenue base. In its Brief, NYNEX stated that it was not opposed to the methodology used by the OPA to arrive at an attrition year growth factor for late payment charges, provided NYNEX's attrition year revenues were used in the calculation.

We infer from that conditional language that unless its revenue projections are used, NYNEX would reject the methodology proposed by the OPA and would instead advocate no increase in late payment revenue. However, NYNEX has not explained why the OPA's methodology is reasonable if NYNEX's revenue projections are used, but unreasonable if another reasonable revenue projection is used. NYNEX must expect that any application of the methodology would result in some growth in late payment revenues. We find that the method proposed by the OPA is reasonable and will use it to calculate late payment revenues in the attrition year.

4. Other Expenses

In its direct testimony, NYNEX witness Micciche recommended a 4.48% annual increase in "Other" expenses between the test year and the rate year. The Staff's witness, Mr. Dirmeier, proposed a 3.5% annual growth rate in his direct testimony. OPA witness Catlin calculated a trended growth rate. In his direct testimony, Mr. Catlin proposed an annual growth rate of 1.84%, but the OPA revised that recommendation in its Brief to a 1.77% annual increase. NYNEX in its direct testimony had calculated a compound annual growth rate, but agreed that Mr. Catlin's methodology produced a more accurate result. NYNEX used it in its rebuttal testimony to produce a 3.32% trended growth rate for the period 1988 to 1993. The Staff in its Brief agreed with NYNEX's growth rate.

Although the parties ultimately agreed on methodology, the OPA eliminated from its trending analysis the 11.66% growth experienced in 1988 to 1989 because it was "abnormally" high. Eliminating that year from the analysis reduced the trended growth rate to 1.96% at the rebuttal stage¹³. The OPA also calculated the differential between the historic growth rate in other expenses and the rate of inflation over the same time period. Adding that negative differential to the projected 3.1% rate of inflation yielded a growth estimate of 1.77%.

NYNEX argued that the 1988 to 1989 period should not be excluded because one of the advantages of the continuous growth equation is that it smooths out year-to-year variability and avoids the problem of attempting to eliminate certain data from the analysis. NYNEX also argues that it is inappropriate to add the negative differential between the growth in other expenses and historic inflation. Part of the reason NYNEX has been able to hold the line on costs has been due to its

¹³The OPA also accepted NYNEX's clarification of its response to Staff Data Request 5-27 related to a normalization adjustment in 1993. This resulted in a reduction of \$1.451 million to the 1993 expense instead of the \$4.153 million originally reflected in the OPA's direct testimony. This adjustment, in connection with the elimination of the 1988 expenses, resulted in the trended growth rate for the 1989 to 1993 time period of 1.96%.

earlier restructurings and those savings are reflected in the historic growth rate. Thus, applying the differential to the expected inflation rate may result in recognition of double savings in the attrition year because NYNEX has separately accounted for the cumulative savings and costs associated with the current PRE effort.

We agree conceptually with the OPA's proposal to apply a differential to a current projection. If such a differential existed in the past, it is appropriate to assume that such a relationship will continue in the future if no evidence to the contrary is offered. However, NYNEX has suggested that the historic differential embodies the impacts of prior restructurings. Assuming those prior restructurings produced savings, NYNEX is correct that excluding the current restructuring savings from the analysis and reflecting them separately could result in capturing those savings twice. However, the scope of the current restructuring is far in excess of any previous efforts and therefore its impacts should not be viewed as indicative of prior results.

If 1988 were included in the analysis, the trended growth rate during 1988 to 1993 would be 3.4%¹⁴ and the inflation adjusted rate would be 2.94%. We are not convinced that all of the differential can be assumed to have been a result of previous restructurings. We believe that NYNEX should continue to look for ways to control costs in the future. We find that an annual growth rate of 2.94% is reasonable.

5. Uncollectible Revenues

NYNEX recommended use of the 2.03% uncollectible rate experienced for the 12 months ended December 1994 as an appropriate rate for the attrition year. The OPA has agreed to this rate. The Staff advocated the use of 1.95%, which reflects the rate achieved by NYNEX for the 12 months ended September 1994.

No party has proposed an average uncollectible rate based on historic experience, a methodology employed by the Commission in recently decided rate proceedings. While this methodology is permissible when no clear trend is present, it would not properly reflect the consistent downward trend in the uncollectible rate recently experienced by NYNEX. All parties proposed to use post-test year experience to project a future uncollectible rate. That approach is acceptable because of the clear downward trend in the rate. We find no reason why the 12-month period ended September 1994 is preferable to the 12 months ended December 1994. We therefore accept NYNEX's recommendation of a 2.03% uncollectible rate for the attrition year.

¹⁴NYNEX calculated a trended growth rate for 1988 to 1993 of 3.32%. We were unable to recalculate this rate using Mr. Catlin's trending model. Our calculations yielded a rate of 3.4%.

6. Plant in Service and Depreciation Reserve

NYNEX's witness, Mr. Micciche, recommended that growth rates of 4.5% and 9.0% be applied to test year plant in service and depreciation reserve, respectively. The Staff's witness, Mr. Dirmeier, apparently adopted NYNEX's position as he incorporated both the 4.5% and the 9.0% growth rates in the schedules of his direct testimony. The OPA's witness, Mr. Catlin, recommended an alternative methodology in which 1994 and 1995 period activity is added to the December 31, 1993 balances to arrive at projected December 31, 1995 balances in both the plant in service and depreciation reserve accounts. The resulting December 31, 1995 plant in service balance was then converted to a average rate year balance.

The use of Mr. Catlin's methodology for calculating the plant in service balance was accepted by NYNEX on rebuttal. Because the Staff offered no supporting testimony for the 4.5% growth rate, and because the OPA and NYNEX agreed that the OPA's methodology is preferable, we accept the OPA's calculation of the attrition year plant in service balance of \$965.633 million.

NYNEX also accepted the OPA's methodology for calculating depreciation reserve, but with some modifications. NYNEX believed the OPA's analysis was flawed in that it mixed average balances and period activity. We agree with NYNEX's criticism. In the calculation of plant in service, both parties used the average December 31, 1993 plant in service balance as a starting point. Adding period activity to this balance resulted in a plant in service balance for December 31, 1995, which was then converted to an average rate year balance. We find this approach is equally appropriate for the calculation of the depreciation reserve balance. We therefore modify the OPA's methodology to include the December 31, 1993 average depreciation reserve balance of \$405.636 million which NYNEX provided in its rebuttal testimony. Using the \$405.636 million as the base, we calculate a projected depreciation reserve at December 31, 1995 of \$490.098 million. The average reserve balance at May 31, 1994 was less than the end of period balance at December 31, 1993, resulting in a 99.71% conversion factor. We apply this factor to the projected December 31, 1995 balance of \$490.098 million to arrive at a projected May 31, 1996 average depreciation reserve balance of \$488.691 million.

D. NETSAVER Rebate

On June 6, 1989, the Commission approved a comprehensive settlement resolving the Commission's investigation into NYNEX's rates. New England Telephone Company, Investigation of Reasonableness of Rates, Docket No. 88-143, Order (June 6, 1989). The Order incorporates the Stipulation approved by the Commission (hereinafter referred to as Docket No. 88-143 Stipulation). Under the stipulation, NYNEX agreed to reduce intrastate toll rates with an intended result of an annual decrease of \$8 million in its Maine intrastate revenues, net of independent companies' toll settlements and uncollectibles. Docket No. 88-143 Stipulation, Attachment 1. Of that amount, \$5 million was to be used to offset the revenue effect of introducing three new optional calling plans to be filed with the Commission as new services. The three services were NETSAVER Calling Service, NETSAVER PLUS Calling Service and Customized NETSAVER. Under the first two plans, customers pay a monthly fee in exchange for a percentage discount on direct-dialed calls within the Maine LATA. The customized plan offers customers two premium business toll service plans.

At the end of the stipulated term (two years from Commission approval), NYNEX agreed to provide a report to the Staff and other parties reflecting "the revenue effect of these three NETSAVER plans over the term of the Stipulation on a calendar year 1988 billing determinant basis." Docket No. 88-143 Stipulation, Attachment 1 at 3. The monthly average revenue reduction goal was \$416,667. NYNEX agreed to return to its customers a one-time credit equal to the amount by which "the monthly average revenue effect of these plans was less than the monthly average revenue goal multiplied by the number of months the Stipulation remained in effect." *Id.*

On October 6, 1989, NYNEX filed a description of the system it proposed to use to track the revenue effect of the NETSAVER plans on a 1988 billing determinant basis. On July 26, 1991, the Commission approved a June 18, 1991 stipulation in which the parties agreed to extend the terms of the original stipulation for another year. Paragraph 15 of that stipulation required NYNEX to file its report on NETSAVER by July 9, 1991. The Stipulation did not otherwise affect NETSAVER. NYNEX filed the report as required on that date.¹⁵

According to Staff witness Dirmeier quoting from the 1991 Report, the agreed-upon method of tracking the revenue effect "did not accurately reflect a

¹⁵NYNEX, for the first time in its Brief, asked the Commission to take official notice of the July 9, 1991 report. The Hearing Examiner subsequently ruled that the Commission would not take notice of the report. See Procedural Order, Docket Nos. 94-123, 94-254 (Mar. 24, 1994).

customer's actual savings result from NETSAVER and NETSAVER PLUS." NYNEX claimed the method was "ill-conceived" and that the downfall of the system was the underlying assumption that customer calling characteristics would remain constant from 1988. Instead of remaining the same, approximately 50% of the NETSAVER customers increased usage. NYNEX then calculated the savings for NETSAVER and NETSAVER PLUS using 1989 and 1990 billing data that included the increased usage. The 1989 and 1990 calling volumes of the NETSAVER subscribers multiplied by the applicable NETSAVER rate exceeded \$10 million in savings when compared with those same calling volumes priced at regular Message Telecommunications Service (MTS) rates. Based on 1988 test year volumes, the revenue reduction was \$7.209 million, or \$2.791 million less than \$10 million target required by the Stipulation.

The Staff disagrees with NYNEX's proposed change in methodology. It contends NYNEX's attempt to measure the revenue reduction on past test year volumes that were stimulated due to the rate reduction is inconsistent with established ratemaking methodologies. The Staff further contends that the stimulation effect (i.e., customers making more calls at a lower incremental price per call) was precisely the effect that NYNEX and Staff agreed would not be taken into account in the stipulation. The Public Advocate adopted the Staff's position. In response, NYNEX in its Brief and its Reply Brief argues that adjudication of this issue does not belong in this case and should be resolved in the docket in which it originated, Docket No. 88-143. Earlier, on February 2, 1995, NYNEX made the same objection when the Advocacy Staff indicated in its pretrial memorandum that it intended to cross-examination NYNEX witness Micciche on this subject. The matter was discussed during the Case Management Conference on February 3, 1995. The Hearing Examiner issued a ruling from the bench on February 8, 1995 that the NETSAVER issue would be considered in this case.

The issue of whether NYNEX must make a refund pursuant to the stipulation in Docket No. 88-143 was never resolved in the context of that docket. As the Examiner ruled on February 8, 1995, it is our intention to tie up all loose ends before NYNEX begins to operate under an AFOR. See also Public Utilities Commission, Inquiry of New England Telephone Company's Revenue Requirements, Cost of Service and Rate Design, Docket No. 91-200 Order (May 26, 1994) (to the extent issues remained unresolved from the previous NYNEX revenue requirement docket, they will be resolved in Docket No. 94-123 (companion docket to this case)). The Staff raised the NETSAVER issue in its direct testimony. NYNEX chose not to address this issue in its rebuttal testimony that was filed on December 13, except to argue that the issue belonged in Docket No. 88-143. Following the Examiner's ruling, NYNEX did not ask for any further time to respond even though 3 days of hearings remained. Given that all parties had sufficient notice that this is an issue in this case and an opportunity to put forth testimony on the topic, we will resolve the issue here.

The plain language of the stipulation approved by the Commission states that the revenue effect of the NETSAVER plans would be measured using 1988 billing determinants. NYNEX specifically agreed to return to customers a one-time credit equal to the amount by which the monthly average revenue effect was less than the monthly average revenue goal, times the number of months the stipulation remained in effect. Only after the offering ran the 2-year term did NYNEX determine that its agreement to use 1988 billing determinants was ill-conceived. It is apparent that there were no mutual mistakes of fact. To the contrary, the Staff claims it did not want the increased usage factored into the revenue determination.

The comprehensive settlement of a major rate case may include separate agreements about many issues. Nevertheless, the paramount concern of most settling parties is likely the overall amount of a settlement. Thus, as Staff explains in its Brief, if one party were to "get more" out of one of the subagreements (e.g., if the other parties agreed with NYNEX to use stimulated demand for the purpose of measuring NETSAVER savings) then it is highly likely that those other parties would insist on a concession on some other issue or issues, so they would still find the overall amount of the settlement acceptable. We, therefore, will not undo the bargain agreed to in 1989 simply because NYNEX either does not like the result or it failed to anticipate the result of its bargain. The result is neither so unexpected nor so threatening to the financial stability of the utility that we need to reopen our original order approving the stipulation.

According to the Staff, the NETSAVER products resulted in \$7,208,640 in savings in 1988 and 1989 and, therefore, did not meet nor exceed the \$10 million target using 1988 billing determinants. No other party disputed that number. NYNEX therefore shall issue a one-time credit of \$2,791,360 as more fully described in Part V below.

E. Wages and Bonuses

There are two unresolved issues with respect to rate year wage expense. The first involves NYNEX's annualization of rate year wage rate increases, an adjustment opposed by both the Staff and the OPA. The second issue is NYNEX's objection to the OPA's proposed adjustment to eliminate 50% of the costs of its incentive compensation plan. We will address each issue separately.

NYNEX annualized the rate year wage increases in the belief that it does not make sense to establish a revenue requirement based on expenses that do not reflect the full impact of events that will occur prior to the end of the rate effective year. The annualization of the rate year wage increases results in an additional \$1.059 million of revenue requirement.¹⁶ Both the Staff and the OPA argued against the annualization of the rate year wage increases because annualization would reflect increases that will not be in effect for the full rate year.

We agree with the Staff and the OPA. Wage levels in the rate year should reflect actual expenditures for that period and not levels of expenditures that will be incurred in periods beyond the rate effective year. NYNEX argued that refusal to include a wage level representative of rate year operations makes no sense. However, the annualization of a wage increase that occurs during the rate year is not representative of rate year operations. Instead, it reflects operations for the 12 months immediately following the month the increase became effective, which could be as late as the last month of the rate effective year. NYNEX projected growth in wages from the test year to the attrition year of \$5.068 million (which also included a \$20,000 decrease due to an earlier restructuring), while the OPA reflected a \$4.029 million increase. We find a reasonable increase to be \$4.029 million as calculated by the OPA, which does not reflect the annualization proposed by NYNEX.

The OPA has also proposed to eliminate half, or \$662,000, of incentive bonus plan payments NYNEX has included as a cost of service in this proceeding. The purpose of this adjustment is not to adjust for an unreasonable level of compensation but rather to recognize that the benefits of the plan flow only in part to ratepayers. NYNEX has argued that barring a showing that overall compensation levels are excessive, there is no basis to disallow a particular component of the compensation package.

In a number of recent cases, the Commission has addressed the issue of incentive bonus plan payments. Generally, we will not disallow such payments absent a showing that they contribute to overall compensation levels that are unreasonable. Bangor Hydro-Electric Company, Proposed Increase in Rates, Docket No. 93-062, Order at 43 (March 16, 1994). Incentive plan costs may also be disallowed if the plan is not well defined and implemented. In the recent Camden and Rockland, Maine and Wanaqua Water Companies rate case we found that while

¹⁶The Staff was the only party actually to quantify the effect of the annualization. However, we are unable to replicate the Staff's amount of \$1.072 million. The \$1.059 million is based on the difference in OPA's position on Exh. TSC-2, Sch. 5 of Mr. Catlin's Direct Testimony and NYNEX's position on Exh. 7, page 10 of Micciche's Rebuttal Testimony.

the Company should have considerable flexibility in constructing its compensation packages, we do not believe an incentive plan should be fully included in rates without a showing that there is a high probability that the objectives will be met, full payments made, and that ratepayers will be better off. We accept the disallowance proposed by the Staff

Camden and Rockland, Maine and Wanaquah Water Companies, Proposed Increase in Rates, Docket No. 93-145 at 60 (July 12, 1994). Finally, incentive plans will be disallowed if too much emphasis is placed on one goal, such as earnings per share, to the possible detriment of ratepayers. See e.g., Central Maine Power Company, Proposed Increase in Rates, Docket No. 90-076, Order at 93 (Mar. 8, 1991).

The OPA's argument is that the plan will benefit both ratepayers and shareholders and that therefore the costs should be shared. Absent evidence that overall compensation levels are excessive, that payments under the plan are not likely to be distributed, that the incentives are designed to benefit shareholders to the detriment of ratepayers, or that the plan is so poorly designed as to render it unmanageable, we will not order disallowances or changes to NYNEX's incentive compensation plan. We reject the disallowance proposed by the OPA.

F. Out-of-Period Adjustments

This issue arose with the OPA's recommendation that certain non-recurring "out-of-period adjustments" to the test year be reversed to arrive at a normalized test year cost of service. The OPA defined out-of-period adjustments as entries to NYNEX's books of account that are recorded during a given financial period that correct or adjust the operating results of some earlier financial periods. The OPA selected, from a listing of accounting adjustments provided by NYNEX in response to Staff Data Request No. 4-26 (OPA Exh. 133), those out-of-period adjustments that it considered non-recurring, and therefore distortions of the test year. The OPA then eliminated those adjustments from the test year. NYNEX objected to the OPA's selection criteria and instead proposed to eliminate all of the adjustments listed in OPA Exhibit 133 from the test year except for two related to the payment of legal settlements. While the Staff agreed with this type of adjustment from a theoretical standpoint, it decided not to eliminate any of the OPA's or NYNEX's proposed out-of-period adjustments in its calculations because of its inability to evaluate each adjustment independently.

The out-of-period adjustments listed in OPA Exhibit 133 (exclusive of the legal the settlement payments that will be discussed separately below) have a total revenue requirement effect of approximately \$1.4 million. The OPA has proposed to

eliminate from the test year adjustments from that list that would reduce revenue requirements by approximately \$1.5 million. The OPA did not eliminate a \$700,000 adjustment to reverse a write-off that was incorrectly recorded as uncollectible. However, that particular adjustment does not appear to be of consequence since all parties have agreed to use a prospective uncollectible rate to adjust the uncollectible revenue account. See Part IV.F.1. above. The OPA also did not eliminate a \$1.248 million adjustment to decrease toll revenue for independent telephone settlements recorded during the test year. The sum of the remaining adjustments not eliminated by the OPA increase revenue requirements by about \$951,000, consisting of approximately \$711,000 of tax true-ups associated with the Fixed Asset Microcomputer Income Tax System (FAMITS), \$396,000 of overaccrual of pole attachment revenues, and a reduction of \$156,000 for various other adjustments. The OPA left these adjustments in the test year after determining that they are recurring adjustments.

NYNEX agreed with several of the OPA's proposed adjustments including the correction of a Carrier Access Billing System (CABS) billing error, the reversal of a late payment adjustment made to the State of Maine account, and tax adjustments related to the change in tax rates. However, NYNEX has proposed to eliminate the entire list of adjustments, exclusive of legal settlements, and the associated \$1.4 million revenue requirement from the test year in order to reflect only the financial results of the 12 months comprising the test year. NYNEX has suggested that the OPA chose selectively from the list, and with one exception, proposed to reverse only out-of-period adjustments that reduced revenue requirement.

We agree with the OPA that out-of-period adjustments should be removed from the test year if they are nonrecurring. However, it would not be proper to remove an independent company settlements adjustment (for example) if such an adjustment were made each year and in a very similar amount. Knowing that any particular adjustment is likely to recur or not recur is not sufficient by itself to determine whether the particular adjustment in question materially misstates the test year. There is no evidence in this proceeding providing any of the analysis that is necessary to determine whether any of these items, or generally similar items, will not recur. Without such evidence, there is no basis to assume that the out-of-period adjustments are not common or that other out-of-period adjustments do not occur on a regular basis and in similar amounts. There is a strong presumption in favor of test year levels of expenses, and any party proposing an adjustment to the test year at the least must meet a production burden to establish that the proposed adjustment will more accurately reflect the future than the test year. Therefore, we will not include any of the proposed out-of-period adjustments.

G. Other Adjustments

1. Non-Recurring Legal Expense

The OPA removed \$752,000 of expense associated with two legal settlements NYNEX made during the test year. The OPA argued that those amounts should be removed because NYNEX will not incur additional settlement costs for those cases during the rate effective year, and because the amounts are for damages or losses caused by NYNEX's action, they, like penalties and fines, should be eliminated from the costs of service.

NYNEX disagreed with the OPA's characterization of the settlement costs. Legal settlements are not like other non-recurring items in that they represent a valid category of expense and an ongoing cost of doing business. NYNEX argues that if gross negligence or willfulness is not involved, legal settlements should not be viewed as equivalent to fines and penalties that would be subject to disallowances.

The OPA is correct that costs associated with these particular cases will not be incurred in the rate year. However, no evidence was provided to show that legal settlements or legal costs incurred to resolve lawsuits are unusual or unexpected events. NYNEX is correct that these expenses are a part of doing business, and some level of settlement activity can be expected in future years. Without knowledge of what level of settlement expense is typical for NYNEX in a given year, the fact that these costs were recorded via an adjusting entry or that they relate to completed cases is not sufficient to remove them from the test year.

2. Employee Activity Costs

The OPA proposed eliminating \$405,000 of employee activity costs from the test year because they were not necessary for NYNEX to provide utility service and they were not an essential part of overall employee compensation. The OPA believes these expenses are discretionary in nature and that ratepayers should not pay for incentives to encourage employees to achieve at a level required of them. NYNEX argued that these expenses are work-related and therefore benefit customers through the provision of service.

The issue is not whether these costs are discretionary or required to provide service, but whether they are reasonable. It is clear that NYNEX has the discretion to offer achievement and sales awards and whether they choose to or not, service should not suffer. However, the current level of these expenditures represents less than 0.15% of total revenues, an amount that does not appear unreasonable. There may be an amount or specific type of expenditure, however, that would not be appropriate for a utility to pass on to ratepayers. This is not one, and we do not accept this adjustment.

3. Chauffeur Expense

The OPA proposed to eliminate \$17,000 of chauffeur expense from the test year. The OPA argued that the costs are not necessary to provide service to customers. No other party addressed this issue in testimony or brief.

It is clear that NYNEX supplied chauffeurs to five of its officers. NYNEX made no attempt to refute the OPA's characterization of the expense. We will accept the adjustment as proposed.

H. Cost of Service Summary

Having examined each of the individual adjustments to the test year and the attrition year as proposed by the parties, and incorporating the individual adjustments discussed above, we find that a revenue decrease in the amount of \$14,446,000 in the rate year is warranted. We also find attrition year rate base to be \$445,654,000. See attached Exhibits 1-10. This amount is exclusive of the one-time \$2,791,320 NETSAVER rebate.

V. RATE DESIGN

A. Recurring Revenue Requirement

Based on our findings described above for cost of capital (Part II), rate base (Part III), and cost of service (Part IV), NYNEX is directed to reduce its Maine intrastate revenue requirement and rates as of June 1, 1995. NYNEX's reduction in rates will be designed to result in an annual decrease in NYNEX's Maine intrastate revenues of \$14,446,000 net of independent local exchange carriers' toll settlements and uncollectibles. This reduction in rates will be achieved as described below.

1. Touch Tone Service

The Advocacy Staff proposed that Touch Tone Service rates be eliminated, and that Touch Tone Service "should become a component of basic service." Dr. Gabel stated that the incremental cost of Touch Tone Service is essentially zero, and that charges for this service discourage customers from using the service. Dr. Gabel suggested, however, that charges for Touch Tone Service should be phased out over 3 years, because if the price of Touch Tone service is immediately reduced to zero, then there will be less money available to reduce toll rates and Staff preferred seeing both prices drop. No other parties objected to Staff's proposal. Considering the total revenue reduction we have identified in Part V.A above, we will

be able to accomplish both those objectives without delaying total elimination of Touch Tone Service charges.

Thus, an initial increment of the total revenue reduction will be achieved from the elimination of all charges for Touch Tone Service, including all initial nonrecurring service and equipment charges and recurring monthly charges.¹⁷ NYNEX shall file revised schedules of rates, terms, and conditions to implement this rate design element as part of its compliance filing. Touch Tone service shall be made available to all customers without charge automatically within 30 days of the date of this Order, although the ability to dial calls using dial pulse ("rotary") telephones shall be retained.¹⁸ We anticipate that the revenue effect of this rate design change will be approximately \$4.5 million annually.

2. Toll Services

Staff proposed that toll and access rates be reduced, and suggested that NYNEX be provided with some discretion on how to apply toll service rate decreases. Staff witness Gabel recommended, however, that the toll revenue decrease that is applied to MTS should be no less than the proportion of total toll revenues currently generated by MTS.

Staff witness D. Gabel further testified that Maine's toll rates are high relative to rates in other states, and that current levels discourage usage on the network. We have received numerous comments from ratepayers, both in written communications and in testimony at public witness hearings, that reflect concerns about Maine's toll rates as well.¹⁹ No party disagreed with Staff's proposal.

¹⁷NYNEX's description of and monthly rates for Touch Tone Calling Service are contained in Part A, Section 6, ¶ 6.1 of NYNEX's schedule of rates, terms, and conditions for Exchange and Network Services, P.U.C. - Me. - No. 15.

¹⁸There may be some customers with telephones that only have pulse dialing capability. If NYNEX did not retain the ability of its switches to handle pulse-dialed calls, it would be necessary for NYNEX to provide Touch Tone service only to those customers who wanted it and to engage in a costly service ordering process. Providing both Touch Tone and pulse dialing automatically and ubiquitously avoids that problem.

¹⁹We have not heard many concerns from ratepayers about the level of NYNEX basic service rates. In addition, in Docket No. 92-130, we did not find any subsidy flowing from basic services to other services, and therefore no basis for lowering basic service rates on that ground.

The record does not contain any substantive record evidence that would compel us to adopt any particular method for this reduction. In addition, the order initiating this earnings investigation directed that NYNEX should not propose any rate design changes. However, our order in Docket No. 92-130 recognized and implicitly endorsed the goal of the parties to achieve the "objective of reducing toll rates." Docket No. 92-130 Order at 46-47. Accordingly, the remainder of the required revenue reduction we have directed above, after elimination of charges for Touch Tone Service pursuant to Part V.A.1 above and credit to schools and libraries pursuant to Part V.A.3 below, will be achieved from lowering rates for all toll (interexchange) services included in Part A of NYNEX's schedules of rates, terms and conditions for Exchange and Network Services, P.U.C. - Me. - No. 15, including all optional calling plans contained in that Part.

NYNEX shall file revised schedules designed to reduce these rates in an equiproportional manner ("across the board") consistent with the approach described above to achieve the remaining revenue reduction in NYNEX annual revenues of approximately \$5.946 million, including reductions to the common line charge (CLC) element of access charges, which flow from toll reductions, calculated pursuant to MPUC Rules, ch. 280, § 8.C.1. NYNEX shall file revised schedules of rates, terms, and conditions to implement this rate design element as part of its compliance filing.

3. Libraries and Schools

We will allow up to \$4.0 million of the mandated rate reduction to be used to reduce rates and/or provide additional services or equipment to libraries and schools. We do this in the belief that significant benefits to the public may be realized by providing limited support for additional access to information networks and services. Based on the record in these cases and our findings in Part III.C.12 of our AFOR Order, we believe the support at this time should be limited to no more than \$4.0 million per year. We will not at this time prescribe how this support will be used to benefit the libraries and schools, but instead will require NYNEX to file a proposal with the Commission by June 15, 1995. In developing its proposal, NYNEX shall consult with all the parties to this proceeding, particularly the Libraries and Education, who wish to participate in the discussion. In its June 15 filing, NYNEX shall describe its consultations on this matter with all the parties to this proceeding.

The revenue reductions to be implemented on June 1, 1995 will exclude the entire \$4.0 million that may ultimately be allocated to the libraries and schools. We, therefore, order NYNEX to establish an account in which it will accrue \$333,333 per month. This accrual will begin on June 1, 1995 and continue until such time as the Commission approves its proposal to use these amounts. If NYNEX's ultimate proposal uses only a portion of the \$4.0 million to support services to the

libraries and schools, then the remaining portion must be used for toll reductions. In its filing, NYNEX should discuss how its proposal will provide recurring benefits to the libraries and schools equivalent to the recurring benefits that would accrue if the allocated funds were used instead to reduce general toll rates.

B. Non-Recurring Revenue Requirement

Based on our findings in Part IV.D above related to a cost of service adjustment for NYNEX's NETSAVER service, NYNEX is directed to return to its customers a one-time credit of \$2,791,320. Accordingly, NYNEX shall file revised schedules of rates, terms and conditions to apply to each Maine customer's bill for each access line and trunk to achieve the \$2,791,320 total credit within 3 months of the date of this Order. We believe that this credit will be approximately \$4.50 per access line and trunk. NYNEX shall file revised schedules in compliance with this Order within 30 days of the date of this Order.

Accordingly, it is

O R D E R E D

1. By June 1, 1995, NYNEX shall file revised schedules of rates to decrease its Maine intrastate revenue requirement by \$10.446 million, as more particularly described in Parts V.A.1 and V.A.2 of this Order;
2. By June 15, 1995, NYNEX shall file its proposal for providing up to \$4 million to Maine libraries and schools, as described in Part V.A.3 of this Order;
3. By June 1, 1995, NYNEX shall file revised schedules of rates to implement the one-time credit to customers as described in Part V.B above.
4. Docket No. 92-316, Public Utilities Commission, Investigation Into New England Telephone Company's Represcription of Depreciation Rates is hereby closed.

Dated at Augusta, Maine, this 15th day of May, 1995.

BY ORDER OF THE COMMISSION

Marjorie Marcotte
Asst. Administrative Director

COMMISSIONERS VOTING FOR: Welch
 Nugent

This document has been designated for publication.

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of adjudicatory proceedings are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 6(N) of the Commission's Rules of Practice and Procedure (65-407 C.M.R.11) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which consideration is sought.
2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within 30 days of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Civil Procedure, Rule 73 et seq.
3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.

APPENDIX A: PROCEDURAL HISTORY

I. INITIATION OF CURRENT PROCEEDINGS

On April 7, 1994, Governor John R. McKernan, Jr. signed legislation entitled "An Act to Establish an Alternative Form of Telecommunications Regulation in the State." This Act authorizes the Commission to adopt "an alternative form of regulation for any telephone utility in the State." The Act provides conditions for such alternative form of regulation, and requires the Commission to report its activities pursuant to the Act. This legislation, enacted as P.L. 1993 Chapter 638, became effective 90 days following the Legislature's adjournment on July 14, 1994.

On May 10, 1994, in anticipation of the new law, the Commission opened an investigation, pursuant to its authority under 35-A M.R.S.A. §§ 301, 1303, 7101, 7303, and 7501-7506, to investigate possible regulatory alternatives for NYNEX, a public utility operating in Maine. The purpose of this proceeding is to find a regulatory structure that will give NYNEX flexibility to operate in a competitive telecommunications environment, while preserving and enhancing protection of basic ratepayers. Public Utilities Commission, Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company, d/b/a NYNEX, Docket No. 94-123, Notice of Investigation at 2 (May 10, 1994).

On July 13, 1994, the Commission received a complaint against NYNEX, signed by Frederic A. Pease and 12 other persons (Complainants). The complaint, filed pursuant to 35-A M.R.S.A. § 1302, requested that the Commission investigate the level of revenues and earnings of NYNEX. The complaint also asked the Commission to investigate whether some or all of NYNEX's investment in broadband fiber facilities and high speed data facilities should be excluded from its investment base. On July 25, 1994, NYNEX responded to this complaint, stating that sufficient grounds did not exist to warrant a formal investigation, and that the Complainants' cross-subsidy claim lacked merit. NYNEX suggested that if the Commission found that the complaint had merit, the Complainants should be made parties to either or both Docket No. 94-114 (Public Utilities Commission, Inquiry Into the Provision of Competitive Telecommunications Services (Chapter 280) and Docket No. 94-123.

On August 18, 1994, the Commission began an investigation into the issues raised by Complainants, and stated that:

The complaint alleges facts which, if proven, could provide a basis for arguing that not all of NET's [NYNEX's] current investment should be recognized in rates for local or toll services. In addition, we are unwilling to conclude positively that NET's [NYNEX's] earnings are not excessive.

Frederic A. Pease v. New England Telephone Co., Complaint Requesting Commission Investigation of Level of Revenues Being Earned by NET and Determination of Whether Toll and Local Rates Should be Reduced, Docket No. 94-254, Order Initiating Earnings Investigation; Consolidation with Docket No. 94-123 (Aug. 18, 1994) at 4. The Commission ordered NYNEX to file by October 3, 1994 the information and data required by Chapter 120 of the Commission's Rules²⁰ except for filing of proposed rate schedules and rate design information and testimony concerning rate changes. The Commission also consolidated the new investigation with Docket No. 94-123, made lead Complainant Frederic A. Pease a party to both proceedings, and made parties in Docket No. 94-123 parties to the complaint proceeding. *Id.*

II. PARTIES

The following parties were permitted to intervene in these consolidated proceedings (Docket Nos. 94-123 and 94-254):

1. Office of the Public Advocate (OPA);
2. Department of the Secretary of State (State);
3. Neighborhood Action Coalition of Greater Portland (NAC);
4. Maine Association of Interdependent Neighborhoods (MAIN);
5. Maine State Legislative Committee of the American Association of Retired Persons (AARP);
6. Maine Community Access Network (MCAN);
7. Pine Tree Telephone and Telegraph Company (Pine Tree);
8. Hartland & St. Albans Telephone Company, Island Telephone Company, Somerset Telephone Company, and Warren Telephone Company (collectively TDS Companies);
9. MCI Telecommunications Corporation (MCI);
10. AT&T Communications of New England, Inc. (AT&T);

²⁰Certain of these filing requirements were subsequently waived or clarified by Procedural Orders, August 25, 1994 and September 13, 1994.

11. Sprint Communications Company L.P. (Sprint);
12. Atlantic Cellular Telephone Corp. and Piscataqua Cellular Telephone Corp. (Atlantic and Piscataqua);
13. Time Warner Communications (Time Warner) and jointly the New England Cable Television Association, Inc. (NECTA) (collectively, Cable Companies); and
14. Maine Telecommunications Users Group (MTUG);
15. Frederic A. Pease (Pease), lead Complainant in Docket No. 94-254;
16. U.S. Cellular Operating Co. of Bangor, Inc., Lewiston Cell Tel Co., Maine RSA #1, Inc., Maine No. 2 Cellular Telco, Inc., and Maine RSA #4 Limited Partnership (collectively U.S. Cellular Companies);
17. George K. Romoser, (Romoser);
18. Deborah St. Pierre, (St. Pierre);
19. Department of Education (Education); and
20. Maine Library Association, Maine Educational Media Association, and Maine Library Commission (Libraries).

III. PROTECTIVE ORDER

Protective Order No. 1 was issued on November 30, 1994, limiting access to trade secret information or confidential information as described in M.R.Civ.P. 26(c) and M.R.Evid. 507, to Commissioners, Commission Staff, Counsel for parties and independent consultants or experts of parties and Staff.

IV. FILINGS BY PARTIES; HEARINGS

On October 3, 1994, NYNEX filed schedules and testimony of Stephen Micciche, John Cogswell, Francis Tracy, and Alan Reed. On November 15, 1994, NYNEX filed a description of its proposed alternative regulation plan.

On December 13, 1994, the parties filed Structured Comments providing statements of their respective positions on alternative forms of regulation. NYNEX also filed testimony of Edward Dinan, John Conroy, and William Taylor in support of NYNEX's proposal for alternative regulation.

Also on December 13, 1994, Staff filed testimony of David Gabel, Richard Gabel and J. Douglas Cowie, Barbara Alexander, Richard LeLash, and Michael Dirmeier. OPA filed testimony of Thomas Catlin, Randy Allen, Thomas Weiss, and Lee Selwyn.

On January 13, 1995, NYNEX filed rebuttal testimony of Kenneth Helgeson, Stephen Micciche, and John Cogswell.

On January 17, 1995, NYNEX filed rebuttal testimony of Bruce Larsen, Laurits Christensen, and William Taylor. Staff filed rebuttal testimony of Barbara Alexander and David Gabel. OPA filed rebuttal testimony of Lee Selwyn.

Witnesses filing testimony were cross-examined by parties during formal evidentiary hearings conducted in Augusta from February 7 through February 16, 1995. Limited oral surrebuttal was offered during the hearings by Staff witnesses Dirmeier and LeLash, and OPA witnesses Weiss, Allen, and Catlin.

On March 8, 1995, briefs were filed in Docket No. 94-123 by Staff, OPA, NYNEX, AARP, NECTA, MCI, Atlantic and Piscataqua, Education, and Libraries.

On March 10, 1995, briefs were filed in Docket No. 94-254 by Staff, OPA, NYNEX, and AARP. On March 13, 1995, Libraries filed a letter adopting its Brief filed in Docket No. 94-123 for Docket No. 92-254.

On March 16, 1995 reply briefs were filed in Docket No. 94-123 by Staff, OPA, NYNEX, AARP, NECTA, and MCI.

On March 20, 1995, reply briefs were filed in Docket No. 94-254 by Staff, OPA, NYNEX, and AARP.

An Examiners' Report in Docket No. 94-254 was issued on April 11, 1995. Staff, OPA, NYNEX and AARP filed Exceptions to that Examiners' Report.

An Examiners' Report in Docket No. 94-123 was issued on April 19, 1995. Exceptions to that Report were filed by Staff, OPA, NYNEX, AARP, Maine Libraries, MCI, U.S. Cellular Companies, Atlantic and Piscataqua

V. PARTICIPATION BY THE PUBLIC

The Commission conducted Public Witness Hearings during December, 1994, in Portland, Lewiston, Bangor, Augusta, and Presque Isle. Sixty-one representatives of business, economic development, low-income, elderly, library, museum, and educational interests testified as part of those hearing. The Commission also received written correspondence from 45 representatives of business, government, library, museum, non-profit organization, and general public interests.